Supreme Court, U.S.
FILED
OCT 3 1985
JOSEPH F. SPANIOL, JR.
CLERK

(1)

No. 85-592

IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

NATURAL GAS PIPELINE COMPANY OF AMERICA,

Petitioner,

v.

FEDERAL ENERGY REGULATORY COMMISSION,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

CORRECTED COPY

***PAUL E. GOLDSTEIN**
PAUL W. MALLORY
EMMITT C. HOUSE
MidCon Corp.
701 East 22nd Street
Lombard, Illinois 60148
(312) 691-2731
Attorneys for Natural Gas Pipeline Company of America

JOSEPH M. WELLS
Of Counsel

*Counsel of Record

October 3, 1985

Merrill/Chicago • 372-2800

QUESTION PRESENTED

Whether, in a proceeding under Section 4 of the Natural Gas Act involving a proposed increase in resale rates of Natural Gas Pipeline Company of America, the Federal Energy Regulatory Commission acted improperly in denying the recovery in rates of amounts expended by the company in failed natural gas supply projects, thereby disregarding the financial integrity of the company and inconsistently administering the applicable statute.

LIST OF PARTIES

Public Agencies
Federal Energy Regulatory Commission

Interstate Natural Gas Pipeline Companies
Natural Gas Pipeline Company of America

List of Petitioner's Parents, Subsidiaries, and Affiliates Pursuant to Rule 28.1
Natural Gas Pipeline Company of America is a subsidiary of MidCon Corp.
MidCon Corp. is the parent of the following subsidiaries:

Alabama Gulf South Pipeline Company, Inc.
Alabama Methane Production Company
Anthrust, Inc.
Cotton Petroleum Corporation
Exeter Capital Corporation
Exeter Drilling Company
Exeter Exploration Company
Exeter Service Company
Gulf South Pipeline Company
Harper Oil Company
Lynx Drilling Company
MCN Acadian Gas Pipeline Corp.
MCN Bayou Interstate Pipeline Corp.
MCN Calcasieu Gas Gathering Corp.
MCN Coal Gasification Company
MCN Equities, Inc.
MCN Louisiana Industrial Gas
MCN Overseas Inc.
MCN Pelican Interstate Gas Corp.
MCN Pelican Transmission Corp.
MCN Pontchartrain Natural Gas Corp.
MCN Research, Inc.
MCN Spindletop Gas Distribution Corp.
MCN Technologies, Inc.
MCN Transmission, Inc.
MCN Utah Pipeline Corp.
MCN-TEX Corp.
MCN-Trinidad and Tobago LNG Company
MidCon Arkansas Pipeline Corp.
MidCon Colorado Pipeline Corp.

MidCon Acquisition Corp.
MidCon Enterprises, Inc.
MidCon Exploration Company
MidCon Gas Products, Inc.
MidCon General, Inc.
MidCon Holding Corp.
MidCon Hydrocarbons Corp.
MidCon Illinois Pipeline Corp.
MidCon International N.V.
MidCon Louisiana Pipeline Corp.
MidCon Michigan Pipeline Corp.
MidCon Mississippi Natural Gas Pipeline Corp.
MidCon Missouri Pipeline Corp.
MidCon New Mexico Pipeline Corp.
MidCon Oklahoma Natural Gas Pipeline Corp.
MidCon Plants, Inc.
MidCon Razorback Pipeline Corp.
MidCon Sales Inc.
MidCon Texas Pipeline Corp.
MidCon Ventures, Inc.
MidCon Wyoming Pipeline Corp.
MidOk Pipeline Company
MidTex Pipeline Company
MidCon Nebraska Pipeline Corp.
Mississippi Gulf South Transmission Company
Mississippi River Transmission Corporation
NAERCO, Inc.
NGP-LNG, Inc.
Petrounited, Inc.
South Gulf Management, Inc.
TPC Pipeline Company
Texas Gulf South Pipeline Company
Texoma Production Company
Troy Potter Inc.
UER Gas Trading, Inc.
UER Marketing Company
UER Overseas Finance, N.V.
UER Services, Inc.
United Energy Resources, Inc.
United Energy Services Company
United Gas Pipe Line Company
United Texas Transmission Company
Western Energy Transport Company

TABLE OF CONTENTS

	PAGE
Question Presented	i
Parties to the Proceedings	ii
Table of Contents	iv
Table of Authorities	v
Opinions Below	1
Jurisdiction	2
Statutory Provisions	2
Statement of the Case	3
Reasons for Granting the Petition	9
1. The Court of Appeals Erred in Affirming the Commission's Determination That the Abandoned Project Costs Should Be Treated Differently Than Similar Costs the Commission Allows Utilities to Recover	10
2. The Court of Appeals Erred by Disregarding the Pipeline Interest in Affirming the Commission's Determination That the Cost of the Abandoned Gas Supply Projects Must Be Borne Entirely by the Pipeline and Its Shareholders	13
3. The Court of Appeals Erred in Affirming the Commission's Determination That the Abandoned Project Costs Should Be Disallowed Because the Projects Did Not Benefit Ratepayers	15
Conclusion	16

TABLE OF AUTHORITIES

Cases

	PAGE
American Public Gas Assn. v. *F.P.C.*, 546 F. 2d 983 (D.C. Cir. 1976)	14
American Textile Manufacturers Institute, Inc. v. *Donovan*, 452 U.S. 490 (1981)	15
Arkansas Lousiana Gas Company v. *Hall*, 453 U.S. 571 (1981)	15
Burlington Trunk Lines v. *U.S.*, 371 U.S. 156 (1962)	20
F.P.C. v. *Hope Natural Gas Co*, 320 U.S. 591 (1944)	18, 19
F.P.C. v. *Memphis Light, Gas and Water Division, et al.*, 411 U.S. 458 (1973)	18, 19, 20
F.P.C. v. *Sierra Pacific Power Company*, 350 U.S. 348 (1956)	15
F.P.C. v. *Texaco, Inc.*, 417 U.S. 380 (1974)	13
Great Plains Coal Gasification Associates, 9 FERC ¶61,221 (1979), *rev'd and remanded sub nom Office of Consumer's Cousel* v. *FERC*, 655 F. 2d 1132 (D.C. Cir. 1980)	10
Jersey Central Power & Light Company v. *FERC*, 768 F.2d 1500 (1985)	20
Michigan Wisconsin Pipe Line Co. v. *F.P.C.*, 520 F. 2d 84 (D.C. Cir. 1975)	13
Mobil Oil Corp. v. *F.P.C.* 417 U.S. 283 (1974)	21
NEPCO Municipal Rate Committee v. *FERC*, 668 F.2d 1327 (D.C. Cir. 1981)	16, 17
Permian Basin Area Rate Cases, 390 U.S. 747 (1968)	13
Public Service Commission v. *F.P.C.*, 467 F. 2d 361 (D.C. Cir. 1972)	13

PAGE

Statutes

Natural Gas Act, 15 U.S.C. §§717, *et seq.* (1982)

Section 4, 15 U.S.C. §717c 2, 3, 4

Section 5, 15 U.S.C. §717d 2, 3

Section 19, 15 U.S.C. §717r 2

Federal Power Act, 16 U.S.C. §§791a-825u (1985)

Section 205, 16 U.S.C. §824d 15

Section 206, 16 U.S.C. §824e 15

No. 85-592

IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

NATURAL GAS PIPELINE COMPANY OF AMERICA

Petitioner,

v.

FEDERAL ENERGY REGULATORY COMMISSION,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

Petitioner, Natural Gas Pipeline Company of America (Natural) respectfully prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the District of Columbia Circuit entered on July 5, 1985, in *Natural Gas Pipeline Company of America* v. *Federal Energy Regulatory Commission*, No. 84-1351.

OPINIONS BELOW

The opinion of the Court of Appeals is reported at 765 F.2d 1155 (1985). No petition for rehearing was filed with the Court of Appeals. The court below affirmed an opinion and order of the Federal Energy Regulatory Commission (Commission) styled Opinion No. 218, issued on May 7, 1984 (*FERC Opinion*), 27 FERC ¶61,201, which is reproduced at App. 39a-54a. The *FERC Opinion* affirmed in part and modified in part an initial decision of an Administrative Law Judge (ALJ) issued on December 20, 1979, 9 FERC ¶63,059 (*Initial Decision*), which is reproduced at App. 55a-81a. In Opinion No. 218-A issued July 5, 1984, 28 FERC ¶61,020 (1984) (*Rehearing Order*), the Commission denied Natural's

application for rehearing. That opinion is reproduced at App. 37a-38a[1].

JURISDICTION

1. The Court of Appeals affirmed a Commission order requiring Natural to exclude from its cost of service amounts attributable to prudently incurred expenses, contrary to Sections 4 and 5 of the Natural Gas Act (Act), 15 U.S.C. §§717c and 717d. The Commission had jurisdiction to review Natural's rates pursuant to Sections 4 and 5 of the Act. Natural sought court review pursuant to Section 19(b) of the Act, 15 U.S.C. §717r(b).

2. The Court of Appeals entered judgment on July 5, 1985. App. 7a.

3. The jurisdiction of this Court is invoked under 28 U.S.C. ¶1254(l), and Section 19(b) of the Act, 15 U.S.C. ¶717r(b).

STATUTORY PROVISIONS

The pertinent portion of Section 4(e) of the Act, 15 U.S.C. §717c(e), reads as follows:

> (e) Whenever any . . . new schedule is filed the Commission shall have authority, either upon complaint of any State, municipality, State commission, or gas distributing company, or upon its own initiative without complaint, at once, and if it so orders, without answer or formal pleading by the natural-gas company, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and . . . after full hearings, either completed before or after the

1. Petitioner has filed a separate Appendix which contains all opinions in this matter, including the judgment below. Hereinafter the Appendix will be referred to as "App.", followed by the appropriate page number.

> rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective.[2]

The pertinent portion of Section 5(a) of the Act, 15 U.S.C. §717d(a), reads as follows:

> Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order.[3]

STATEMENT OF THE CASE

This case involves review of a decision of the U.S. Court of Appeals for the District of Columbia Circuit affirming orders of the Commission denying Natural the recovery of certain abandoned project costs from its ratepayers.

A. Factual Background

Natural is an interstate gas pipeline company with a 12,000 mile long transmission system which transports natural gas from the Gulf Coast and Southwest producing areas to numerous utility and municipal customers in the Midwest.

---

2. The full text of Section 4(e) is reproduced at App. 1a-2a.

3. The full text of Section 5(a) is reproduced at App. 2a.

Natural is a natural gas company subject to the Commission's rate jurisdiction under Section 4(e) of the Act, 15 U.S.C. §717(e). This case arises out of a general rate increase proposal filed by Natural on June 30, 1978 with the Commission. On July 28, 1978, the Commission suspended Natural's proposed rate increase for the full statutory five month period, permitting the rate increase to become effective, subject to refund and the outcome of a hearing. 4 FERC ¶61,089 (1978).

Natural was able to resolve most of the issues in the case under a settlement agreement which was approved by the Commission. 9 FERC ¶62,005 (1979). Several issues involving costs associated with tax normalization, amortization of unsuccessful and abandoned nontraditional gas supply projects and separation of liquid hydrocarbons remained unresolved by the settlement agreement. The tax normalization issue was consolidated with another proceeding for separate hearing and decision. Following an evidentiary hearing before the ALJ, the *Initial Decision* was issued on the abandoned projects and liquids separation issues. The liquids separation issue was subsequently resolved by a settlement agreement. Thus, the only issue remaining to be decided in this proceeding involves the abandoned gas supply projects.

Natural has not proposed to include the costs of the abandoned projects in its rate base and thereby earn a return of and a return on its investment. It has only sought to recover its out of pocket investment. It has sought to do so by proposing to amortize over a five year period approximately $13 million dollars in costs incurred for three nontraditional gas supply projects: (1) certain environmental costs associated with a coal gasification project in Dunn County, North Dakota (Dunn County Project); (2) costs incurred in Kalingas, a liquefied natural gas (LNG) project in Iran (Kalingas Project); and (3) costs associated with the Gas Arctic Project, an effort to transport gas from the Prudhoe Bay area of Alaska and from Canada to the lower 48 states (Gas Arctic Project). Natural proposed to amortize approximately $1.5 million of the Dunn County Project costs, $4.7 million of the

Kalingas Project costs and $6.7 million of the Gas Arctic Project costs.

The abandoned gas supply projects arose during the 1970s, a period of severe gas shortage experienced by Natural and other natural gas pipelines and consumers. The curtailments to customers resulting from the supply shortage led Natural to seek new sources of gas supplies. In pursuit thereof, Natural participated in a number of nontraditional projects, including advance payments to producers and the abandoned projects at issue in this case.

Traditionally, as an interstate pipeline, Natural was able to rely upon producers to explore for and to develop new gas supplies. The scarcity of supplies and severe curtailment of the early 1970s, however, prompted Natural to conclude that it could no longer rely upon producers alone to develop enough gas for the future needs of its customers. The three nontraditional gas supply projects at issue in this case presented Natural with an opportunity to obtain significant gas supplies in the future, during a time when the deliverability of Natural's traditional gas supplies was insufficient and expected to continue to decline. The facts with respect to Natural's expenditures and its participation in each of the three projects are as follows:

Gas Arctic Project

From 1971 through 1977, in an effort to obtain certificate authorization to transport gas from the Prudhoe Bay area of Alaska and Canada to the lower 48 United States, Natural participated as a member of the Gas Arctic Northwest Project Study Group (Study Group). During that period, Natural had a contract with Imperial Oil Company for gas reserves in the MacKenzie River Valley of the Northwest Territory of Canada and a funding arrangement with Exxon for 20% of its gas production from the Prudhoe Bay Field on the North Slope of Alaska. Natural and the other members of the Study Group funded research for economic, legal, environmental, and engineering studies to determine the feasibility of transporting

Alaskan and Canadian gas via a pipeline through a designated route to the U.S. and Canadian markets. The studies were required to be presented as part of the record in certificate proceedings before the Commission at consolidated Docket Nos. CP75-96, *et al.*

While a different project for the transportation of Arctic gas was ultimately approved by the Commission, the studies prepared by Natural and the Study Group contributed significantly to the Commission's ability to make an informed judgment of the feasibility of the project ultimately authorized. *Initial Decision*, 9 FERC, at p. 65,226-27; App. 70a.

Dunn County Project

Natural was planning to construct a coal gasification facility in Dunn County, North Dakota which would initially produce 250 MMcf of gas per day. In 1973, Natural acquired certain coal leases and an option to purchase property in North Dakota necessary for the Dunn County Project. Natural engaged consultants to prepare the basic studies of the coal gasification process and the other areas required to develop environmental reports required by state and federal regulatory authorities.

The Dunn County project met insuperable regulatory barriers. The North Dakota Water Commission voted to deny Natural's application for a state water permit. Subsequent to completion of Natural's environmental report, two major federal environmental statutes were enacted by Congress. Many new regulations were adopted by federal and state agencies pursuant to the provisions of the new federal statutes, making portions of the previously completed environmental studies outdated and inapplicable. In addition, Natural was unable to finance the project. Therefore, Natural's Dunn County Project activities were suspended and it is unlikely that the project could be completed.

Kalingas Project

In late 1975, Chicago Bridge and Iron Company (CBI) offered Natural an opportunity to participate as an interest owner in the Kalingas Project—a consortium of companies organized to export LNG from Iran for deliveries commencing as early as 1982. At that time, Kalingas offered the only available source of LNG to Natural for deliveries as soon as the early 1980's. Natural and CBI entered into an agreement requiring the payment by Natural to CBI of $4.5 million which gave Natural a future right to buy a 5% interest in Kalingas. Natural was required to enter into this agreement in order to preserve its right to purchase gas at a later date. A 5% interest in Kalingas would have given Natural the right to purchase 400 MMcf per day of LNG production from Kalingas, adding approximately 2400 Bcf of gas reserves to Natural's gas supply, assuming deliveries over a twenty year period. Natural pursued the Kalingas Project because it offered Natural the opportunity to secure a long term gas supply backed by substantial reserves with deliveries commencing by about 1982. The gas supply for the Kalingas project was to be produced from a field in offshore Iran.

By 1977, it became apparent that implementation of the Kalingas project would have required participation by Natural of much more than 5%, and probably not less than a 15% interest. Natural was unable and unwilling to undertake to commit to such a large percentage ownership. Accordingly, Natural declined to exercise its right to purchase 5% of Kalingas and consequently, forfeited its previous payment of $4.3 million to CBI. Subsequently, the Kalingas project was restructured. While the restructured project appeared to be economically feasible, if physical implementation of the project could have been undertaken by a date certain, any delays beyond that date certain would result in severe cost escalations. In 1977, at the time that Natural was required to decide whether to make a firm commitment to purchase LNG from

the restructured Kalingas project, the viability of other potential LNG sources, notably Trinidad and Nigeria, began emerging. The opportunity to secure an LNG supply from one or both of those sources, together with the likelihood of severe escalations in the restructured Kalingas project, led Natural to decline to participate further in the Kalingas Project.

B. Proceedings Below

In the *Initial Decision*, the ALJ allowed Natural recovery of the Dunn County Project costs on the grounds that the Commission's determinations in the Great Plains Coal Gasification proceedings, decided in *Great Plains Coal Gasification Associates*, 9 FERC ¶61,221 (1979), *rev'd and remanded sub nom Office of Consumer's Cousel* v. *FERC*, 655 F. 2d 1132 (D.C. Cir. 1980) (*Great Plains*), permitted it. *Initial Decision*, 9 FERC at p. 65,230; App. 79a-80a. The ALJ disallowed most of the Kalingas Project costs because be believed they were foreign advance payments which were not recoverable under applicable Commission precedent. The ALJ did, however, permit Natural the recovery of a small amount of administrative expenses of the Kalingas Project because he considered them "routine" administrative costs. *Intital Decision*, 9 FERC at p. 65,226; App. 69a. The ALJ did not allow Natural recovery of Arctic Gas Project costs because he believed that the recovery of those costs should be addressed in a rulemaking proceeding to ensure a uniform result among the numerous pipelines which could make claims for such costs. *Initial Decision*, 9 FERC at p. 65,227; App. 72a-74a.

In the *FERC Opinion*, the Commission disallowed Natural recovery of all costs of the three abandoned projects. With respect to the disallowance of Dunn County Project costs, the Commission stated that it was precluded from permitting such costs by the *Great Plains* case and that the instant decision was consistent with its policy of denying recovery of potentially nonjurisdictional synthetic natural gas costs. Similarly, the Commission found that all of the Kalingas Project costs should be disallowed because the project would have

produced gas which would not necessarily have been within the jurisdiction of the Commission to regulate. The Commission stated that both the Kalingas and Dunn County projects were highly speculative, with any benefits to consumers remote and uncertain. The Commission therefore concluded that the costs associated with those projects were properly borne by the shareholders of Natural, rather than the ratepayers.

As to the Gas Arctic Project costs, the Commission noted that it had issued two decisions in individual pipeline rate cases disallowing the recovery of similar costs. The Commission therefore concluded that the same result should obtain for Natural's Gas Arctic Project costs.

With respect to any inconsistency between the Act and the Federal Power Act, the Commission stated that differences in its certificate authority under the two statutes justifies any difference in treatment accorded unsuccessful gas and electric projects. The Commission similarly dismissed arguments that its disallowance of Natural's abandoned project costs was inconsistent with its determination involving abandoned gas storage costs and producer dry hole costs.

Generally, the Commission concluded that the abandoned project costs must be disallowed because the projects were considered "speculative and uncertain, remote in time, and without benefit to ratepayers." In the *Rehearing Order*, the Commission affirmed its determination in the *FERC Opinion* without modification.

REASONS FOR GRANTING PETITION

The Court of Appeals' affirmance of the Commission's ruling that Natural is not entitled to recover the costs of the abandoned projects in its rates not only is erroneous, as is shown below, but presents questions of major importance warranting review by this Court. The issue transcends this particular case and will likely continue to be presented to this

Court in the future because of other existing controversies[4] and future gas supply exigencies. The issue is of signal importance to the natural gas industry because it involves the Commission's responsibility with respect to the financial integrity of pipelines which act in a prudent fashion to supplement gas supplies during periods of severe shortage. One of the major responsibilities of the Commission under the Act is to assure an adequate gas supply for the ultimate consumers. *See e.g.*, *F.P.C.* v. *Texaco, Inc.*, 417 U.S. 380, 388 (1974); *Permian Basin Area Cases*, 390 U.S. 747, 795-99 (1968); *Public Service Commission* v. *F.P.C.*, 467 F. 2d 361, 368-69 (D.C. Cir. 1972). The abandoned projects at issue were intended to increase the total gas supply available to Natural's customers, thereby contributing to the fulfillment of gas requirements which were going unfulfilled in a period of severe shortage. The holding below drastically undercuts the incentive of pipelines to meet gas service obligations when faced with shortages from traditional gas supply sources.

1. The Court of Appeals Erred in Affirming the Commission's Determination That the Abandoned Project Costs Should Be Treated Differently Than Similar Costs the Commission Allows Utilities to Recover.

The Commission is obliged to act in a manner that is consistent and even-handed in dealing with similar issues on different pipeline systems and the Court of Appeals has consistently required the Commission to do so in the past. *Michigan Wisconsin Pipe Line Co.* v. *F.P.C.*, 520 F. 2d 84, 89 (D.C. Cir. 1975); *American Public Gas Assn.* v. *F.P.C.*, 546 F. 2d 983, 988 (D.C. Cir. 1976). Yet, in this case, the Court of Appeals, on the basis of assertions wholly unsupported by the

---

4. There are currently several cases at various stages of litigation in which the recovery of abandoned project costs in pipeline rates is at issue. One such case, *Transwestern Pipeline Company* v. *FERC*, is before the U.S. Court of Appeals for the Fifth Circuit at Docket No. 84-4753. Two others, *Algonquin Gas Company*, 31 FERC ¶61,221 (1985), and *Tennessee Gas Pipeline Company*, 32 FERC ¶61,086 (1985) are pending in proceedings before the Commission.

record and arbitrary conclusions, upheld the Commission's determination that the recovery of Natural's abandoned project costs should be treated differently than similar costs the Commission allows utilities to recover.

The Commission and the Court of Appeals erroneously distinguished the recovery of Natural's abandoned project costs from the allowed recovery of abandoned gas storage projects, abandoned nuclear power plants and dry well costs. While conceding that the Commission has allowed the recovery of the costs of abandoned gas storage projects, the Court of Appeals erroneously and without any support in the record asserted that storage is a necessity for pipelines and that storage projects are necessary for maintaining the equipment of a pipeline. 765 F. 2d at 1165; App. 28a. The Court of Appeals concluded on the basis of such arbitrary assertion, that Natural's abandoned projects were more akin to production activity and therefore distinguishable from storage projects. The plain truth is that storage is simply a means by which some gas pipelines attempt to enhance their gas supply availability and it has nothing to do with maintaining pipeline equipment. In fact, abandoned storage projects are fundamentally indistinguishable from Natural's abandoned gas supply projects. Both failed storage projects and Natural's failed projects are subject to the same standard of review under the Act. Being indistinguishable, they should be treated by the Commission in the same fashion. The Court of Appeal's decision is thus based upon a misapprehension of the evidence and is grounds for reversal by this Court. *American Textile Manufacturers Institute, Inc.* v. *Donovan*, 452 U.S. 490, 523 (1981).

With respect to abandoned nuclear projects, evaluated under the Federal Power Act, 16 U.S.C. §§791a-825u, the Court of Appeals' analysis is similarly unavailing. The Court of Appeals ignored the well established principle that comparable provisions of the Federal Power Act and the Natural

Gas Act "are in all material respects substantially identical".[5] *Arkansas Lousiana Gas Company* v. *Hall*, 453 U.S. 571, 577 n.7 (1981); *F.P.C.* v. *Sierra Pacific Power Company*, 350 U.S. 348, 353 (1956). Rather, the Court of Appeals accepted the Commission's spurious reasoning that Natural's abandoned projects were highly speculative with remote and uncertain benefits to ratepayers,[6] as enough to justify different treatment than is accorded abandoned nuclear projects. Even if the Commission's finding concerning benefits to ratepayers were correct, that fact alone does not justify the difference in treatment accorded Natural's abandoned gas supply projects. Abandoned projects by definition, whether storage or nuclear power plants, are failed efforts to provide utility service to ratepayers. If, as is conceded, the recovery of the costs of such efforts is appropriately allowed in the gas storage and nuclear contexts, neither the Court of Appeals nor the Commission has offered any rational reason for treating Natural's abandoned projects differently. Failed nuclear projects and gas storage projects, as well as Natural's abandoned gas supply projects are evaluated under substantially the same statutes. All such projects are fundamentally indistinguishable because they all represent efforts by utilities to supplement their supply to provide service to ratepayers. The same policy considerations that justify recovery by other utilities of similar costs dictate the same result in this case. The Court of Appeals has recognized and approved those considerations in cases involving abandoned nuclear projects. For example, in *NEPCO Municipal Rate Committee* v. *FERC*, 668 F.2d 1327, 1333 (D.C. Cir. 1981), the Court held:

> Because it would be inequitable to place on the utility the entire loss of expenditures prudent when made, FERC allowed recovery thereof over time. At the same time, FERC is charged with a duty to pro-

---

5. Sections 205 and 206 of the Federal Power Act, 16 U.S.C. §§824d and 824e, are substantially the same as Sections 4(e) and 5(a) of the Act. Sections 205 and 206 are reproduced in App. 4a-6a.

6. See discussion at pp. 20-21, *infra*.

> tect the consumer against unreasonably high rates . . . . FERC here struck a reasonable balance between the interests of investors and ratepayers.

The Court of Appeals offers no reasoned analysis for its departure from the principle that similar issues should be decided consistently under the Federal Power Act and the Natural Gas Act. Indeed, the Court of Appeals simply evaded the issue of the Commission's obligation to make consistent determinations in cases involving substantially similar issues by dismissing the issue in a conclusory fashion as involving "complex policy questions" and being "complicated" and "most involved". 765 F.2d at 1167-68; App. 34a. The Court of Appeals should have required the Commission to accord Natural's failed projects the same treatment as failed gas storage and nuclear power projects.

2. The Court of Appeals Erred by Disregarding the Pipeline Interest In Affirming the Commission's Determination That the Cost of the Abandoned Gas Supply Projects Must Be Borne Entirely by the Pipeline and Its Shareholders.

It is well settled that in establishing just and reasonable rates, the Commission must not only meet the objective of protecting the interests of consumers, but must also promote the financial well being of gas pipelines by ensuring the maintenance of revenues sufficient to recover operating expenses and capital costs, as well as revenues sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital. *F.P.C.* v. *Hope Natural Gas Co*, 320 U.S. 591, 603 (1944) (*Hope*); *F.P.C.* v. *Memphis Light, Gas and Water Division, et al.*, 411 U.S. 458, 465-66 (1973) (*Memphis*). Thus, in its determination of pipeline rates, the Commission must not only give weight to ratepayer or consumer interests, but also the financial health of the pipeline. This Court has reversed decisions where a rate determination was reflective of the protection of only one of

those interests. In *Memphis*, 411 U.S. at 474, this Court noted that under the criteria established in the *Hope* case:

> rates are 'just and reasonable' only if consumer interests are protected and if the financial health of the pipeline in our economic system remains strong.

The present case presents a similar circumstance to the one addressed in *Memphis*.

In this case, the Commission and the Court of Appeals found that it was a proper exercise of the Commission's discretion for it to determine that the pipeline, and thereby its shareholders, must bear the full risk of abandoned project costs, even when such costs have been prudently incurred. Such a determination reflects only the interests of consumers and reflects no consideration for the financial consequences to the pipeline shareholders.

On the other hand, to allow the pipeline to recover abandoned project costs by amortizing and including unamortized amounts in rate base would permit the pipeline to fully recover all such costs and could be characterized as reflective solely of the interests of the company. Only a determination which gives weight to both pipeline and consumer interests, such as Natural's proposal to amortize costs over a five year period, would comport with the standard enunciated in *Hope* and *Memphis*. In upholding the Commission's disregard for pipeline financial consequences, the Court of Appeals appears to have sought to mitigate the error at one point in the opinion by suggesting that some vague concept of "entreprenurial risk" is a necessary component of a pipeline's rate of return. 765 F.2d at 1167, n. 15; App. 33a. The concept, however, is an arbitrary assumption of the Court of Appeals unsupported by any evidence in the record of the case. Such an unsubstantiated assumption should have no bearing on the resolution of this case. In any event, the "entreprenurial risk" assertion is the only reference in the Court of Appeals decision which alludes to any consideration of the financial consequences of disallowance to the pipeline. Thus, the Court

of Appeals appears to have acquiesced to the Commission view that the interests of ratepayers is paramount in a determination of abandoned project cost risk allocation. The Court of Appeals' affirmance that ratepayer interests are paramount is an abdication of its obligation to review Commission decisions with a view to *Hope* criteria. *Cf. Jersey Central Power & Light Company* v. *FERC*, 768 F.2d 1500 (1985).

3. The Court of Appeals Erred in Affirming the Commission's Determination that the Abandoned Project Costs Should Be Disallowed Because the Projects Did Not Benefit Ratepayers.

To withstand judicial review, Commission determinations must be supported by substantial evidence and there must be a rational connection between the facts found and the choice made. *Burlington Trunk Lines* v. *U.S.*, 371 U.S. 156, 168 (1962). In this case, the Court of Appeals failed to apply that standard of review in upholding the Commission's decisions. The Court of Appeals held that the Commission's determination that the public interest in seeing that ratepayers do not pay for services not received is dispositive. 765 F.2d at 1164; App. 27a. The basis for the Court's decision appears to be the Commission's finding that the abandoned project costs were highly speculative and any benefit to consumers was remote and uncertain. Such a finding, however, is completely unsupported by the record in this case. The record is uncontroverted and the ALJ specifically found in the *Initial Decision* that all three projects were planned, or were the preliminary to plans, to enhance the gas supply available to Natural's customers and that the need for the gas could hardly be questioned. *Initial Decision*, 9 FERC at p. 65,225; App. 66a. Such facts, considered against the backdrop of the severe gas shortage in existence when the projects were commenced, in no way leads to the conclusion that the projects would not benefit ratepayers. For the Commission to conclude that the projects "were and would not likely be of benefit to consumers" is to totally ignore the record. The Court of Appeal's affirmance of such a conclusion is a gross misappli-

cation of the requirement that Commission decisions be based on substantial evidence. *See Mobil Oil Corp.* v. *F.P.C.* 417 U.S. 283, 327 (1974).

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

NATURAL GAS PIPELINE
COMPANY OF AMERICA

Paul E. Goldstein
Attorney for Petitioner
Natural Gas Pipeline
Company of America

October 3, 1985

Paul E. Goldstein, Esq.*
Paul W. Mallory, Esq.
Emmitt C. House, Esq.
701 East 22nd Street
Lombard, Illinois 60148
(312) 691-2731

Attorneys for Natural Gas Pipeline Company of America

Joseph M. Wells, Esq.
Of Counsel

*Counsel of Record

FILED
OCT 3 1985
JOSEPH F. SPANIOL, JR.
CLERK

No. 85-592

IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

NATURAL GAS PIPELINE COMPANY OF AMERICA,

Petitioner

v.

FEDERAL ENERGY REGULATORY COMMISSION,

Respondent.

APPENDIX TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

***PAUL E. GOLDSTEIN**
PAUL W. MALLORY
EMMITT C. HOUSE
MidCon Corp.
701 East 22nd Street
Lombard, Illinois 60148
(312) 691-2731
Attorneys for Natural Gas Pipeline Company of America

JOSEPH M. WELLS
Of Counsel

*Counsel of Record

October 3, 1985

Merrill/Chicago • 372-2800

TABLE OF CONTENTS

PAGE

Statutes

Natural Gas Act, 15 U.S.C. §§717, *et seq.* (1982)
Section 4, 15 U.S.C. §717c 1a
Section 5, 15 U.S.C. §717d 2a
Section 19, 15 U.S.C. §717r 2a
Federal Power Act, 16 U.S.C. §791a-825u (1985)
Section 205, 16 U.S.C. §824d 4a
Section 206, 16 U.S.C. §824e 6a

Case

Natural Gas Pipeline Company of America v. *Federal Energy Regulatory Commission*, 785 F.2d 1155 (D.C. Cir. 1985) 7a

Commission Opinions

Natural Gas Pipeline Company of America, Opinion No. 218, 27 FERC ¶61,201 (1984) 39a
Natural Gas Pipeline Company of America, Opinion No. 218-A, 28 FERC ¶61,020 (1984) 37a

Administrative Law Judge Decision

Natural Gas Pipeline Company of America, 9 FERC ¶63,059 (1979) 55a

§ 717c. Rates and charges; schedules; suspension of new rates

(e) Whenever any such new schedule is filed the Commission shall have authority, either upon complaint of any State, municipality, State commission or gas distributing company, or upon its own initiative without complaint, at once, and if it so orders, without answer or formal pleading by the natural-gas company, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the natural-gas company affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect; and after full hearings, either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made at the expiration of the suspension period, on motion of the natural-gas company making the filing, the proposed change of rate, charge, classification, or service shall go into effect. Where increased rates or charges are thus made effective, the Commission may, by order, require the natural-gas company to furnish a bond, to be approved by the Commission, to refund any amounts ordered by the Commission, to keep accurate accounts in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts were paid, and, upon completion of the hearing and decision, to order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the natural-gas company, and the Commission shall give to the hearing and decision of such questions preference

over other questions pending before it and decide the same as speedily as possible.

June 21, 1938, c. 556, § 4, 52 Stat. 822; May 21, 1962, Pub.L. 87-454, 76 Stat. 72.

§ 717d. Fixing rates and charges; determination of cost of production or transportation

(a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: *Provided, however,* That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates.

§ 717r. Rehearings; court review of orders

(a) Any person, State, municipality, or State commission aggrieved by an order issued by the Commission in a proceeding under this chapter to which such person, State, municipality, or State commission is a party may apply for a rehearing within thirty days after the issuance of such order. The application for rehearing shall set forth specifically the ground or grounds upon which such application is based. Upon such application the Commission shall have power to

grant or deny rehearing or to abrogate or modify its order without further hearing. Unless the Commission acts upon the application for rehearing within thirty days after it is filed, such application may be deemed to have been denied. No proceeding to review any order of the Commission shall be brought by any person unless such person shall have made application to the Commission for a rehearing thereon. Until the record in a proceeding shall have been filed in a court of appeals, as provided in subsection (b) of this section, the Commission may at any time, upon reasonable notice and in such manner as it shall deem proper, modify or set aside, in whole or in part, any finding or order made or issued by it under the provisions of this chapter.

(b) Any party to a proceeding under this chapter aggrieved by an order issued by the Commission in such proceeding may obtain a review of such order in the court of appeals of the United States for any circuit wherein the natural-gas company to which the order relates is located or has its principal place of business, or in the United States Court of Appeals for the District of Columbia, by filing in such court, within sixty days after the order of the Commission upon the application for rehearing, a written petition praying that the order of the Commission be modified or set aside in whole or in part. A copy of such petition shall forthwith be transmitted by the clerk of the court to any member of the Commission and thereupon the Commission shall file with the court the record upon which the order complained of was entered, as provided in section 2112 of Title 28. Upon the filing of such petition such court shall have jurisdiction, which upon the filing of the record with it shall be exclusive, to affirm, modify, or set aside such order in whole or in part. No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission in the application for rehearing unless there is reasonable ground for failure so to do. The finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. If any party shall apply to the court for leave to adduce additional evidence, and shall show

to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence in the proceedings before the Commission, the court may order such additional evidence to be taken before the Commission and to be adduced upon the hearing in such manner and upon such terms and conditions as to the court may seem proper. The Commission may modify its findings as to the facts by reason of the additional evidence so taken, and it shall file with the court such modified or new findings, which if supported by substantial evidence, shall be conclusive, and its recommendation, if any, for the modification or setting aside of the original order. The judgment and decree of the court, affirming, modifying, or setting aside, in whole or in part, any such order of the Commission, shall be final, subject to review by the Supreme Court of the United States upon certiorari or certification as provided in sections 346 and 347 of Title 28.

(c) The filing of an application for rehearing under subsection (a) of this section shall not, unless specifically ordered by the Commission, operate as a stay of the Commission's order. The commencement of proceedings under subsection (b) of this section shall not, unless specifically ordered by the court, operate as a stay of the Commission's order.

June 21, 1938, c. 556, § 19, 52 Stat. 831; June 25, 1948, c. 646, § 32(a), 62 Stat. 991; May 24, 1949, c. 139, § 127, 63 Stat. 107; Aug. 28, 1958, Pub.L. 85-791, § 19, 72 Stat. 947.

824d. Rates and charges; schedules; suspension of new rates; automatic adjustment clauses

(e) Suspension of new rates; hearings; five month period

Whenever any such new schedule is filed the Commission shall have authority, either upon complaint or upon its own initiative without complaint, at once, and, if it so orders, without answer or formal pleading by the public utility, but upon reasonable notice, to enter upon a hearing concerning

the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the public utility affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect; and after full hearings, either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made at the expiration of such five months, the proposed change of rate, charge, classification, or service shall go into effect at the end of such period, but in case of a proposed increased rate or charge, the Commission may by order require the interested public utility or public utilities to keep accurate account in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts are paid, and upon completion of the hearing and decision may by further order require such public utility or public utilities to refund, with interest, to the persons in whose behalf such amounts were paid, such portion of such increased rates or charges as by its decision shall be found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the public utility, and the Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible.

§ 824e. Power of Commission to fix rates and charges; determination of cost of production or transmission

(a) Unjust or preferential rates, etc.

Whenever the Commission, after a hearing had upon its own motion or upon complaint, shall find that any rate, charge, or classification, demanded, observed, charged, or collected by any public utility for any transmission or sale subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order.

(June 10, 1920, c. 285, § 206, as added Aug. 26, 1935, c. 687, Title II, § 213, 49 Stat. 852.)

UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT
UNITED STATES COURTHOUSE
333 CONSTITUTION AVENUE, N.W.
WASHINGTON, D. C. 20001-2866

GEORGE A. FISHER
CLERK

GENERAL INFORMATION
(202) 535-3300

July 5, 1985

RE: No. 84-1351 - Natural Gas Pipeline Company of America v. Federal Energy Regulatory Commission

Dear Counsel:

Enclosed herewith are three (3) copies of the opinion in the above entitled case.

Please note that the judgment has been entered on the same date as the opinion and is for mandate purposes only.

Sincerely,

Denise C. Thomas
Opinions Clerk

enclosures

DISTRIBUTION:

Paul E. Goldstein, Esquire
A. Karen Hill, Atty-at-Law

No. 84-1351

IN THE

United States Court of Appeals

DISTRICT OF COLUMBIA CIRCUIT

NATURAL GAS PIPELINE COMPANY OF AMERICA,

Petitioner,

v.

FEDERAL ENERGY REGULATORY COMMISSION,

Respondent.

Argued April 30, 1985.

Decided July 5, 1985.

Natural gas pipeline company petitioned for review of order of Federal Energy Regulatory Commission that rejected company's efforts to recover from its ratepayers, through its cost of service, expenses incurred in unsuccessful, abandoned gas supply projects. The Court of Appeals, Wald, Circuit Judge, held that: (1) pipeline company was not entitled to amortization of expenses of abandoned projects on ground that the expenses were prudently incurred; (2) Commission's disallowance of the costs was consistent with Commission decisions allowing recovery of costs for unsuccessful pipeline storage projects, dry holes drilled by natural gas producers, and unsuccessful electrical generation projects; and (3) Commission properly denied pipeline company's request for rehearing.

Petition denied.

1. Gas — 6, 14.4(7)

Federal Energy Regulatory Commission may attach conditions to certificate of public convenience and necessity for proposed gas pipeline, and conditions may include apportionment of risk between pipeline company shareholders and ratepayers if project fails. Alaska Natural Gas Transportation Act of 1976, § 12, 15 U.S.C.A. § 719j; Natural Gas Act, § 1 *et seq.*, 15 U.S.C.A. § 717 *et seq.*

2. Gas — 14.4(7)

Natural gas pipeline company was not entitled to amortization of expenses of unsuccessful and abandoned gas supply projects on ground that the expenses were prudently incurred. Natural Gas Act, § 1 *et seq.*, 15 U.S.C.A. § 717 *et seq.*

3. Gas — 14.4(7)

Federal Energy Regulatory Commission's rejection of natural gas pipeline company's efforts to recover from ratepayers, through its cost of service, expenses incurred in unsuccessful, abandoned gas supply projects was consistent with Commission decisions allowing recovery of costs for unsuccessful pipeline storage projects, dry holes drilled by natural gas producers, and unsuccessful electrical generation projects, in that the pipeline company's projects were unusually risky ventures that were distinct programs to supplement conventional gas sources, rather than unsuccessful aspects of general exploration program that did produce some gas for consumers, and in that Commission had no authority to rule on electrical generation projects before they were constructed, while all of pipeline company's expenses in question were incurred in unsuccessful pursuit of certificate of public convenience and necessity. Federal Power Act. § 321 *et seq.*, as amended, 16 U.S.C.A. § 791a *et seq.*; Natural Gas Act, §§ 1(b,c), 2(6), 7(c), 15 U.S.C.A. §§ 717(b, c), 717a(6), 717f(c).

4. Electricity — 11.3(4)
Gas — 14.4(7)

Federal Energy Regulatory Commission is not required to adopt single general policy for natural gas and electrical industries governing recovery of money lost in abandoned supply projects, in view of complex policy questions that are relevant in determining appropriate treatment of these losses.

5. Public Utilties — 139

In setting rates within just and reasonable range, Federal Energy Regulatory Commission may consider what future activities it wishes to encourage.

6. Gas — 14.3(3)

Natural gas pipeline company could not claim it was unfairly surprised, and was not entitled to rehearing in its efforts to recover from ratepayers, through its cost of service, expenses incurred in unsuccessful, abandoned gas supply projects, by virtue of Commission's announcement of potential new standard for failed natural gas supply projects, when the Commission would not in any event have applied that standard to the projects at issue.

Petition for Review of an Order of the Federal Energy Regulatory Commission.

Emmitt C. House, Chicago, Ill., with whom Paul E. Goldstein, Chicago, Ill., and Paul W. Mallory, Lombard, Ill., were on brief, for petitioner.

A. Karen Hill, Attorney, F.E.R.C., Washington, D.C., with whom Barbara J. Weller, Deputy Sol., F.E.R.C., Washington, D.C., was on brief, for respondent.

Before WALD and MIKVA, Circuit Judges, and WEIGEL, Senior District Judge.*

Opinion for the Court filed by Circuit Judge WALD.

WALD, Circuit Judge:

Natural Gas Pipeline Company of America (Natural) challenges an order of the Federal Energy Regulatory Commission that rejected Natural's efforts to recover from its ratepayers, through its cost of service, about 13 million dollars Natural spent in pursuit of three unsuccessful gas supply projects. *See Natural Gas Pipeline Co. of Am.*, 27 F.E.R.C. ¶ 61,201 (1984). Although Natural never achieved any natural gas production from these projects and ultimately abandoned its investments in them, Natural claims that it acted prudently in attempting to develop these new sources of supply in a time of natural gas shortages. According to Natural, it should therefore be allowed to recover certain costs from these projects, amortized over five years, from its ratepayers. Natural does not seek to include the project in its rate base and has thus forgone any return on its investment or recovery of debt. It seeks only its out-of-pocket costs.

The Commission replies that a utility may ordinarily recover the costs of natural gas production projects only if the projects are "used and useful" in serving the public and the project costs consequently qualify for inclusion in rate base. *See, e.g., Tennessee Gas Pipeline Co.* v. *FERC*, 606 F.2d 1094, 1109 & n. 53 (D.C.Cir.1979), *cert. denied*, 445 U.S. 920, 100 S.Ct. 1284, 63 L.Ed.2d 605 *and* 447 U.S. 922, 100 S.Ct. 3012, 65 L.Ed.2d 1113 (1980). Production projects that never produce any natural gas are not, in the Commission's view, "used and useful" in this sense. Similarly, the Commission has refused to consider non-recurring capital expenditures for unconventional gas production projects that fail in early stages as operating expenses. It therefore will not allow recov-

---

* The Honorable Stanley A. Weigel of the United States District Court for the Northern District of California, sitting by designation pursuant to 28 U.S.C. § 294(d).

ery from ratepayers of those expenditures through a utility's cost of service. Money lost on such projects thus generally comes out of a utility's approved rate of return. The Commission treats the costs of failed electrical generation projects differently, but it argues that the rationale for this policy does not apply to the natural gas industry. We find the Commission's order to be a reasoned exercise of its discretion under section 4 of the Natural Gas Act, 15 U.S.C. § 717c. We therefore deny the petition for review.

I. BACKGROUND

A. *The Used and Useful Standard*

The Natural Gas Act permits the Commission[1] to approve charges for natural gas subject to the Commission's jurisdiction only if those charges are "just and reasonable." Natural Gas Act, § 4(a), 15 U.S.C. § 717c(a). In reviewing rates to decide whether they are just and reasonable, the Commission decides what the utility's cost of service should be, assuming that the utility is prudently managed. In calculating the utility's cost of service, the Commission includes its operating expenses, depreciation expenses, taxes, and a reasonable return on the net valuation of the property devoted to the public service. *See* P. Garfield & W. Lovejoy, Public Utility Economics 56 (1964). The Commission decides what property is devoted to the public service by asking whether the property is "used and useful" in serving the public.

As this court has frequently noted, the "used and useful" standard derives from the Supreme Court's opinion in *Smyth*

---

1. Throughout this opinion we use "the Commission" to refer to both the Federal Energy Regulatory Commission and its predecessor, the Federal Power Commission.

v. Ames, 169 U.S. 466, 18 S.Ct. 418, 42 L.Ed. 819 (1898).[2] *In Smyth*,

> the Supreme Court articulated the guiding principle that "the basis of all calculations as to the reasonableness of rates to be charged by a [public utility] must be the fair value of the property *being used by it for the convenience of the public.*" [*Smyth*, 169 U.S. at 546, 18 S.Ct. at 434 (emphasis added).] Although methods for determining values of rate base items have evolved since *Smyth v. Ames*, the precept endures that an item may be included in a rate base only when it is "used and useful" in providing service. In other words, current rate payers should bear only legitimate costs of providing service to them. The [Commission] early adopted the "used and useful" standard and has not departed from it without careful consideration of the wisdom of requiring current rate payers to bear costs of providing future service.

Tennessee Gas Pipeline Co. v. FERC, 606 F.2d 1094, 1109 (D.C.Cir.1979) (footnotes omitted), *cert. denied*, 445 U.S. 920, 100 S.Ct. 1284, 63 L.Ed.2d 605 *and* 447 U.S. 922, 100

---

2. *Smyth* remains an important early statement of the used and useful standard. *Cf. Denver Union Stock Yard Co. v. United States*, 304 U.S. 470, 475, 58 S.Ct. 990, 994, 82 L.Ed. 1469 (1938) (under Constitution, stockyard "is not entitled to have included any property not used and useful" to render services in property on which return is calculated) (citation omitted). However, *Smyth* and some other early Supreme Court opinions may be read to emphasize judicial notions of "fair value" as a constitutional standard for ratemaking and to suggest that courts should closely scrutinize ratemaking methodology to be certain that rates reflect fair value. *See Smyth*, 169 U.S. at 546-47, 18 S.Ct. at 434. That reading of *Smyth* has not survived. *See Federal Power Comm'n v. Natural Gas Co.*, 320 U.S. 591, 601-03, 64 S.Ct. 281, 287-88, 88 L.Ed. 333 (1944); *Federal Power Comm'n v. Natural Gas Pipeline Co.*, 315 U.S. 575, 585-86, 62 S.Ct. 736, 742-43, 86 L.Ed. 1037 (1942); *id.* at 601-07, 62 S.Ct. at 750-53 (Black, Douglas, and Murphy, JJ., concurring); *Farmers Union Cent. Exch. v. FERC*, 584 F.2d 408, 413-14 & n. 8 (D.C.Cir.), *cert. denied*, 439 U.S. 995, 99 S.Ct. 596, 58 L.Ed.2d 669 (1978).

S.Ct. 3012, 65 L.Ed.2d, 1113 (1980). In this case, Natural does not seek to include the challenged expenses in its rate base, on which the utility's rate of return is calculated. That step would have the effect of allowing Natural a return on its investment in failed projects, which Natural does not seek. Instead, it wishes to amortize its out-of-pocket costs, without debt or carrying charges, over five years, and then add those amortized charges to its cost of service. Thus, over five years Natural would recover the disputed costs dollar for dollar from ratepayers.[3] Of course, the exclusion of debt carrying charges means that Natural would not completely recover its real costs. The difference between those real costs and the charges Natural proposed to include in its cost of service would be paid out of Natural's rate of return, and consequently would be borne by Natural's shareholders.[4] Natural correctly points out that for this reason, its proposed rate shared the risk of the failed projects between shareholders and ratepayers.

In essence, Natural argues that it should be allowed to recover, through its cost of service, prudently incurred expenses for failed gas supply projects. Because Natural acted blamelessly in incurring these expenditures, it believes the expenditures should be included in the utility's routine cost of service. The Commission maintains that the expenditures were not used and useful to ratepayers, and are properly seen as nonrecurring capital expenditures that, under Commission precedents, may not ordinarily be included in a utility's cost of service. In the Commission's view, they are therefore a risk to be shouldered by the shareholders.

---

3. However, as we note below, Natural did not seek to include all its expenses from the three projects at issue in the disputed costs. *See infra* at 1158-1159.

4. Charges initially borne by the shareholders of a utility may, as we discuss below, ultimately cause rates to increase. *See infra* at 1167-1168.

B. ***Natural's Proposed Rate Filing***

Natural is a pipeline company which transports natural gas through an elaborate interstate system. Natural generally obtains natural gas from producers in southwestern and gulf coast states and transports the gas through its Amarillo and Gulf Coast pipelines to utilities and municipalities in the Chicago area and elsewhere in the midwest. *See generally Natural Gas Pipeline Co. of Am.*, 27 F.E.R.C. ¶ 61,201 (1984) [hereinafter cited as FERC Op.), *aff'g in part and modifying in part* 9 F.E.R.C. ¶ 63,059 (A.L.J. 1979) [hereinafter cited as ALJ Op.], *reh'g denied*, 28 F.E.R.C. ¶ 61,020 (1984).

On June 30, 1978, Natural filed a proposal for a general rate increase with the Commission. On July 28, 1978 the Commission accepted the filing, suspended the rate increase, *see* 15 U.S.C. § 717c(e), and set the rate increase for hearing before an administrative law judge. *See Natural Gas Pipeline Co. of Am.*, 4 F.E.R.C. ¶ 61,089 (1978). The rate increase went into effect on December 1, 1978, subject to refunds the Commission might subsequently order.

Eighteen distributors of natural gas in the area served by Natural and one industrial user of natural gas intervened in the case. After numerous conferences, the parties agreed on all but three issues in the case, and the Commission approved a settlement reflecting that agreement. *See* 9 F.E.R.C. ¶ 62,006 (1978). Two of the three remaining issues have since been independently settled;[5] the third issue is the one before us today.

That issue concerns Natural's efforts to recover costs associated with three abandoned gas supply projects: a syn-

---

5. One of the other disputed issues, which concerned tax normalization, was severed from this proceeding and consolidated with a separate case before the Commission. Natural Gas Pipeline Co. of Am., 13 F.E.R.C. ¶ 61,266 (1980), *reh'g denied*, 21 F.E.R.C. ¶ 61,119 (1982). A second issue, which concerned onshore separation of liquids, was ultimately resolved by settlements in related proceedings. *See* Natural Gas Pipeline Co. of Am., 28 F.E.R.C. ¶ 61,109 (1984); High Island Offshore Sys., 26 F.E.R.C. ¶ 61,302 (1984).

thetic natural gas ("SNG") facility in North Dakota (the Dunn County project), a liquified natural gas ("LNG") project in Iran (the Kalingas project), and a pipeline to transport gas from Prudhoe Bay, Alaska, to the lower 48 states (the Gas Arctic project). Natural undertook these projects at a time when its supply of gas was steadily falling and serious natural gas shortages were believed to be imminent. *See generally* A. Tussing & C. Barlow, The Natural Gas Industry: Evolution, Structure, and Economics 62-91 (1984); Allison, *Natural Gas Pricing: The Eternal Debate*, 37 Baylor L.Rev. 1, 17-18 (1985).

In 1973 and 1974, Natural acquired leases on coal-producing property in North Dakota and an option to purchase property on which a facility to produce SNG through a coal gasification process could be built. In 1976, however, the water commission in North Dakota voted to deny the proposed facility an essential water permit. Natural had prepared an environmental assessment to comply with various state and federal regulatory requirements, but passage of amendments to the Clean Air Act and the Surface Mining Control and Reclamation Act, as well as promulgation of new regulations, rendered much of the environmental assessment outdated. *See* FERC Op. at 61,376-77. Financing and design problems also surfaced. *See* ALJ Op. at 65,228. Confronted with these obstacles, Natural suspended work on the project. In this proceeding Natural seeks to recover approximately 1.474 million dollars it spent on environmental studies made obsolete by new legislation and regulations. *See id.* Natural reported to the Commission that it spent about 3 million dollars on "environmental and process-related" studies for the Dunn County project, *id.*,and approximately 11.7 million dollars on the entire project, *see* FERC Op. at 61,377.

Natural's involvement in the Kalingas project dates from 1975, when Natural joined a consortium of companies organized to produce natural gas from a field off the coast of Iran, liquefy the gas obtained, and export the LNG. Natural normally operates as a pipeline, not a producer, but Natural was

apparently required to participate in production of the gas in order to obtain an option to purchase the liquefied natural gas produced. Natural initially paid 4.5 million dollars for an option to purchase a five percent interest in the project for an additional 3 million dollars. That additional 3 million dollars would also have purchased the right to a call of 400 million cubic feet per day of LNG from the project. *See* FERC Op. at 61,377; ALJ Op. at 65,225.

Within two years, the projected costs of the venture went up dramatically. Had Natural continued its participation in the project, it would probably have been required to triple its participation from five percent to fifteen percent, with corresponding increases in costs. At that time less costly sources of LNG began to appear on the horizon. In 1977 Natural decided to abandon the Kalingas project and forfeit its 4.5 million dollar deposit. Natural now seeks to recover that deposit and $224,824 in related administrative expenses. *See* FERC Op. at 61,377; ALJ Op at 675,226; *see also infra* note 7.

From 1971 to 1977 Natural was involved in the Gas Arctic Northwest Project Study Group. That group, which included numerous energy companies, was principally formed to study various engineering, environmental, financial, and legal problems associated with construction of a pipeline from Prudhoe Bay, Alaska, to the lower 48 states. The Commission ultimately approved a pipeline along a route quite different from that initially proposed by the group. In approving that route, however, the Commission considered Arctic Gas studies explaining how various environmental problems raised by the pipeline could be overcome.[6] Natural

---

6. *See* ALJ Op. at 65,226. The initial decision in the Alaska pipeline case was Alaskan Natural Gas Transp. Project, 58 F.P.C. 1127 (A.L.J.1977); the Commission issued its recommendation to the President under § 5 of the Alaska Natural Gas Transportation Act of 1976, 15 U.S.C. § 719c, in Alaska Natural Gas Transp. Sys., 58 F.P.C. 810 (1977). The administrative law judge in the Alaskan pipeline case relied on Gas Arctic studies to analyze technical details of the competing projects, *see, e.g.*, 58 F.P.C. at 1261, and the Commission in turn relied on the findings of the administrative law judge.

requests reimbursement for about 6.7 million dollars spent on various studies submitted in support of the Gas Arctic proposed pipeline route.

C. *The Administrative Decisions*

The administrative law judge allowed Natural to recover the costs it claimed from the Dunn County project. He recognized that the Commission's previous opinions had stressed an "established policy of disallowing the costs of unsuccessful alternate gas supply projects ... in jurisdictional rates," ALJ Op. at 65,229 (quoting *Northern Natural Gas Co.*, 4 F.E.R.C. ¶ 61,312 at 61,706 (1978) (further citations omitted)). He noted, however, that in *Great Plains Gasification Associates*, 9 F.E.R.C. ¶ 61,221 (1979), *rev'd and remanded sub nom. Office of Consumers' Counsel* v. *FERC*, 655 F.2d 1132 (D.C.Cir. 1980), the Commission decided to permit recovery of costs on an SNG project, even before the project produced any gas. The administrative law judge concluded that the Commission's *Great Plains* decision, read together with other Commission decisions, required him to allow the Dunn County project costs. *See* ALJ Op. at 65,230. The administrative law judge also decided that Natural's 4.5 million dollar deposit in the Kalingas project was, in effect, an advance payment for foreign gas. He interpreted Commission precedents to have "steadfastly denied [recovery of] any advance payments for foreign supplies," ALJ Op. at 65,226, and therefore disallowed costs from the Kalingas project.[7] The administrative law judge further observed that many companies other than Natural had participated in the Gas Arctic project, and that costs resulting from the project should be treated in the same way for each participant. He accordingly concluded

---

7. The administrative law judge did, however, allow Natural to recover $244,824 in routine administrative expenses connected with the Kalingas project. *See* ALJ Op. at 65,226. The Commission held that administrative expenses connected with the project should not be treated differently from other project expenses, and therefore disallowed this item. *See* FERC Op. at 61,381. Natural does not challenge the Commission's decision that all project expenses should be treated similarly.

that recovery of these costs should be addressed in a future rulemaking, not an individual rate case, and therefore disallowed Natural's Gas Arctic costs without prejudice to future recovery after such a rulemaking. *See* ALJ Op. at 65,227-28.

The Commission disallowed costs from all three projects. It rejected the administrative law judge's allowance of the Dunn County project costs based on *Great Plains* for two reasons. First, *Great Plains* had permitted recovery of costs from a coal gasification plant only because that plant, unlike Natural's proposed facility in Dunn County, had been formally approved by the Commission as a research, development, and demonstration plant. *See* 18 C.F.R. § 154.38(d)(5) (1984). Second, this court ultimately overturned the Commission's allowance of costs in *Great Plains*, on the ground that the Commission lacked statutory authority to regulate and arrange financing for commercial SNG facilities before such facilities went into service.[8] *See* FERC Op. at 61,879. The Commission found that enforcement of its general policy prohibiting recovery of costs for natural gas plants that are

---

8. In overturning *Great Plains*, this court held that the Commission has no direct regulatory authority over sales of SNG unless the SNG is commingled with other natural gas. *See Office of Consumers' Counsel* v. *FERC*, 655 F.2d 1132, 1145-46 (D.C.Cir.1980); *Henry* v. *Federal Power Comm'n*, 513 F.2d 395, 401 (D.C.Cir.1975). In this case, the Commission suggested there may be some doubt whether it is statutorily permitted to impose on ratepayers losses sustained from failed SNG facilities. *See* FERC Op. at 61,383 n. 9; *see also Office of Consumers' Counsel*, 655 F.2d at 1148 ("Nothing in this holding denies FERC any authority it may have to consider the costs of production of synthetic gas in the course of considering jurisdictional sales rate filings and petitions under Section 4 of the Gas Act . . . ."); *cf. Public Utilities Comm'n* v. *FERC*, 660 F.2d 821 (D.C.Cir.1981) (holding that FERC may permit natural gas companies to recover in regulated rates certain expenditures for research and development on projects not directly related to interstate commerce in natural gas), *cert. denied*, 456 U.S. 944, 102 S.Ct. 2009, 72 L.Ed.2d 466 (1982). Elsewhere in its opinion, however, the Commission speculated that in the future these expenditures, if prudently incurred, might be recoverable. *See* FERC Op. at 61,381. In any event, the Commission ultimately declined to decide whether it may authorize recovery of SNG losses in jurisdictional rates, *id.* at 61,383 n. 9, and we express no view on this issue.

not used and useful was particularly appropriate in cases involving SNG, since the Commission lacks jurisdiction to regulate the price at which pipelines sell such gas unless the gas is mixed with natural gas extracted from mineral deposits. *See id.* at 61,879-80. "The Commission's concern is that if a project is successful, the pipeline will stand beyond the reach of Commission authority and reap the benefits, while if it is unsuccessful, ratepayers will be saddled with the loss." *Id.* at 61,880 (citation omitted).

The Commission commented that it would also have lacked authority to regulate the price of any LNG produced from the Kalingas project sold outside the United States.[9] Similarly, the price charged for shipping LNG from the project to the United States would have been outside the Commission's jurisdiction. The same considerations that led to

---

9. Section 3 of the Natural Gas Act provides in part that "no person shall . . . import any natural gas from a foreign country without first having secured an order of the Commission authorizing it to do so. The Commission shall issue such order upon application, unless, after opportunity for hearing, it finds that the proposed . . . importation will not be consistent with the public interest." 15 U.S.C. § 717b. Sections 301(b) and 402(f) of the Department of Energy Organization Act, 42 U.S.C. §§ 7151(b), 7172(f), assigned the Secretary of Energy authority over applications to import natural gas. Under DOE Delegation Order No. 0204-111, 49 Fed. Reg. 6,684, 6,690 (1984), the Secretary's authority over these applications is exercised by the Administrator of the Economic Regulatory Administration. *See* 10 C.F.R. Pt. 590 (1985) (regulations governing applications); *cf. West Virginia Public Servs. Comm'n* v. *United States Dep't of Energy*, 681 F.2d 847, 853-59 (D.C.Cir. 1982) (discussing scope of § 3); *Distrigas Corp.* v. *Federal Power Comm'n*, 495 F.2d 1057, 1064 (D.C.Cir.) (discussing § 3 authority formerly exercised by *Federal Power Commission*), *cert. denied*, 419 U.S. 834, 95 S.Ct. 59, 42 L.Ed.2d 60 (1974).

Importation of natural gas from the Kalingas project to the United States would thus have been subject to federal supervision under § 3. In addition, the Commission would have had independent authority to regulate the construction of facilities to receive or ship natural gas from the Kalingas project in interstate commerce or the sale of that gas in interstate commerce or for interstate resale. *See* Natural Gas Act §§ 1(b), 4, 7, 15 U.S.C. §§ 717(b), 717c, 717f; *West Virginia Public Servs. Comm'n*, 681 F.2d at 856 n. 38.

disallowance of the Dunn County costs thus applied to the Kalingas plant. More fundamentally, the Commission concluded that the Dunn County and Kalingas projects were "highly speculative and any potential benefit to consumers was remote and uncertain." FERC Op. at 61,381; *see also id.* at 61,379. The Commission declared that the risk of failure in such ventures was properly borne by shareholders rather than ratepayers. *See id.* at 61,381.

The Commission also noted that in two decisions issued after the administrative law judge's decision in this case, the Commission had refused Gas Arctic participants permission to amortize costs associated with the projects. *See id.* at 61,381-82 (citing *Michigan Wisconsin Pipeline Co.*, 13 F.E.R.C. ¶ 61,254 (1980); *Columbia Gas Transmission Corp.*, 13 F.E.R.C. ¶ 61,102 at 61,222 (1980)). Thus, the concern the administrative law judge had expressed that project participants be treated similarly now supported outright denial of the costs, rather than postponement of the question to a general rulemaking. In *Columbia Gas*, a natural gas pipeline sought to amortize and include in cost of service some of its expenditures on the Gas Arctic project, and to include its remaining expenditures on the project in rate base. 13 F.E.R.C. at 61,222. The Commission decided that expenditures on the Gas Arctic project were not "used and useful" to ratepayers and were therefore not recoverable in either cost of service or rate base. *Id.* The Commission explained that:

> Expenses incurred subsequent to [a filing with the Commission seeking a certificate approving a proposed pipeline] in pursuit of a certificate ultimately not granted are entrepreneurial in character and are not recoverable in rate base . . . . If a project fails and produces no new supply of gas, permitting the pipeline to include its expenditures in its rate base and amortize them through the cost of service would shift the risk from the stockholder to the ratepayer, although the pipeline receives a rate of return to compensate it for business risks. The used and use-

ful principle does not permit the pipeline to shift the risk of loss by imposing the expense of the unsuccessful project upon its current ratepayers who have received no benefit from the project.

Id. The Commission found that the reasoning in *Columbia Gas* supporting denial of costs applied equally to Natural. *See* FERC Op. at 61,382.

This petition for review followed.

II. THE LEGALITY OF THE COMMISSION'S DECISION

A. *The Commission's Refusal to Apply the Prudence Standard*

As the Commission noted in its opinion, it has long refused to include in regulated rates the costs of failed projects to develop new supplies of natural gas. In *Test Eastern Transmission Corp.*, 58 F.P.C. 2412 (1977), for example the Commission commented that:

> We have recently reaffirmed our established policy of disallowing the costs of unsuccessful alternate gas supply projects to be included in jurisdictional rates. In those cases we have held that, while we endorse such efforts as potentially beneficial to the interstate market, we view the risks associated with such efforts as properly borne by the shareholders and not the jurisdictional ratepayer.

Id. at 2422-23 (footnote omitted); *see also Northern Natural Gas Co.*, 4 F.E.R.C. ¶ 61,312 at 61,705-06 (1978).

Transcontinental Gas Pipe Line Corp., 58 F.P.C. 2038 (1977), *aff'd in relevant part and remanded on other grounds sub nom. Tennessee Gas Pipeline Co. v. FERC*, 606 F.2d 1094 (D.C.Cir.1979), *cert. denied*, 445 U.S. 920, 100 S.Ct 1284, 63 L.Ed.2d60s *and* 447 U.S. 922, 100 S.Ct. 3012, 65 L.Ed.2d 1113 (1980), was among the cases in which the Commission disallowed expenses from unsuccessful alternate gas supply projects. In *Transcontinental Gas*, the pipeline sought to

include expenses associated with four failed SNG plants in its rate base, or alternatively to amortize those expenses over five years and include the amortized expenses in the utility's cost of service. The Commission rejected both proposals for essentially three reasons. First, the Commission had not approved the plants at issue as research, development, and demonstration projects. Thus, Commission decisions allowing inclusion in rate base of costs from such projects were inapposite. *See id.* at 2042-43. Second, "the obvious fact that these projects were unsuccessful removes them from that general precept that the costs of exotic supplies, whether SNG or LNG, are recouped along with a fair rate of return *through the pipeline sales of such supplies.*" *Id.* at 2043 (emphasis added). Third, the Commission noted that it lacked authority to regulate the price of SNG. *See supra* note 8. Although in the Commission's view, "that fact alone is not dispositive," 58 F.P.C. at 2043, its lack of regulatory power was relevant because:

> In that SNG projects are nonjurisdictional, the pipeline has the option to either sell the production in intrastate commerce so as to totally avoid Commission regulation or to obtain Commission certification of the transportation and/or sale of the SNG in interstate commerce. The potential for abuse by the pipeline is apparent . . . : If the project is a success, it can choose to sell the SNG in intrastate commerce, but, if the project fails and produces no SNG, the pipeline merely includes the expenditures in rate base and amortizes them through the cost of service. No protection has been afforded the jurisdictional ratepayer under this scenario.

Id. The Commission concluded that:

> Although we support further SNG development, the jurisdictional ratepayer should not bear the full risk . . . Production of SNG by the pipeline is analogous to the production of natural gas by independent producers . . . and the same shareholder risk should apply.

Id. at 2044. Finally, the Commission rejected Transcontinental's offer of a settlement under which some of the disputed expenses would be included in the utility's cost of service, but not in its rate base. "Although the cost to the consumer would obviously be less [under the cost of service proposal than under the rate base proposal, the cost to the consumer under the cost of service proposal] would nevertheless be more than what we have already determined to be the proper treatment, which is no recovery." *Id.* at 2045.

This court found no difficulty in upholding this aspect of the Commission's order. We explained that:

> The Commission found that the expenditures were not "used and useful" in providing service and should not be charged to the rate payers. Since the projects did not produce any jurisdictional gas, ruling clearly was a proper exercise of discretion . . . These expenditures were prudent investments, argues [the pipeline]; however, for rate base inclusion expenditures must satisfy not only the necessary condition of prudent investment but must also be "used and useful" in providing service.

Tennessee Gas, 606 F.2d at 1123 (footnotes omitted). We therefore approved the Commission's rejection of both rate base treatment, *id.*, and inclusion in cost of service, *id.* at 1124, for the expenses at issue. *Cf. Tennessee Gas Pipeline Co. v. Federal Power Comm'n*, 487 F.2d 1189, 1196-97 (D.C.Cir.1973) (upholding FPC's interpretation of certificate for LNG plant to deny rate base treatment of unrecovered expenses when LNG plant failed to produce any gas).

[1,2] In this case, Natural claims that it is entitled to amortization of the expenses of the abandoned projects if those expenses were prudently incurred. We think that our 1979 decision in *Tennessee Gas* forecloses so broad an argument. There, as here, a pipeline company sought to include expenses for failed gas supply projects in its cost of service on the ground that those expenses were prudently incurred. The

Commission invoked the same general policy at issue in this case to refuse the pipeline's request, and this court explicitly approved that policy. Admittedly, in the decision under review in *Tennessee Gas*, the Commission noted that if the pipeline had sold any SNG actually produced in intrastate commerce, the Commission would have lacked authority to regulate the price of that SNG. *See Transcontinental Gas*, 58 F.P.C. at 2048. In this case, one of the projects, the Kalingas project, was outside the United States and consequently beyond the Commission's regulatory jurisdiction. Another, the Dunn County project, was an SNG facility and thus also beyond the Commission's jurisdiction. The third project involved in this case, the Gas Arctic project, would if successful apparently have produced gas subject to at least some of the Commission's regulatory powers.[10] Thus, if *Tennessee Gas* turned on the Commission's lack of authority to regulate SNG not commingled with other natural gas, the case might not control our disposition of the Gas Artic expenses here.

As we have already noted, the Commission's order we reviewed in *Tennessee Gas* explicitly stated that the nonjurisdictional character of SNG was "not dispositive." *Transcontinental Gas*, 58 F.P.C. at 2043. More importantly, this court's discussion of the Commission's ruling attached no importance at all to this subsidiary aspect of the Commission's ruling: instead, we approved the Commission's general policy that "current rate payers should bear only legitimate costs of providing service to them." *Tennessee Gas*, 606 F.2d at 1109. The Commission, we found, could reasonably apply that policy to deny a natural gas pipeline any recovery of costs

---

10. When the Commision grants a certificate of public convenience and necessity, as the Gas Arctic group asked the Commission to do for its proposed pipeline, the Commission may attach conditions to the certificate. *See* Alaskan Natural Gas Transp. Project, 58 F.P.C. 1127, 1144-46 (A.L.J. 1977); *see also* Alaska Natural Gas Transportation Act of 1976, § 12, 15 U.S.C. § 719j (exports of Alaska natural gas subject to Natural Gas Act); *cf. supra* note 6. As the Commission commented in this case, those conditions may include an apportionment of risk between shareholders and ratepayers if the project fails. *See* FERC Op. at 61,379-80, 61,383 n. 8.

from supply projects that entirely failed to benefit ratepayers. *See id.* at 1123-24. That rationale applies equally to the case at hand.

In any event, we think the approach taken in *Tennessee Gas* yields a sensible result in this case. At bottom, Natural's claim is that because it acted prudently, it cannot fairly be punished by nonrecovery of its expenses. But the problem of risk allocation in this case is not a problem of fault. The Commission did not find that the disputed expenditures were imprudent, and we therefore assume that the natural gas pipeline and its ratepayers were equally blameless for the losses at issue. That assumption, however, need not lead to the conclusion that Natural's ratepayers must, through the utility's cost of service, make good on all or any part of the money Natural lost. The Natural Gas Act simply does not guarantee the shareholders of even a prudently managed utility that ratepayers can always be stuck with the bill for supply projects that turn out to be total failures, however praiseworthy the utility's motives for undertaking those projects may have been. In reviewing rates, we ask whether the Commission reasonably found that the rates may "be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interests, both existing and foreseeable. The court's responsibility is not to supplant the Commission's balance of these interests with one more nearly to its liking, but instead to assure itself that the Commission has given reasoned consideration to each of the pertinent factors." *Permian Basin Area Rate Cases*, 390 U.S. 747, 792, 88 S.Ct. 1344,

1373, 20 L.Ed.2d 312 (1968).[11] In this case, the Commission in effect decided that the public interest in seeing that ratepayers do not pay for services not received was dispositive. While the Commission might have struck the balance otherwise,[12] we are unable to say that its judgment was arbitrary. Moreover, Natural does not even argue that the resulting rates are outside the "zone of reasonableness," *Federal Power Comm'n* v. *Natural Gas Pipeline Co.*, 315 U.S. 575, 585, 62 S.Ct. 736, 742, 86 L.Ed. 1037 (1982), within which the Commission may fix rates. We accordingly reject Natural's suggestion that the questioned rates were unlawful merely because the Commission refused to include the expenses at issue in calculating Natural's cost of service.

B. Natural's Claim of Inconsistent Treatment

[3] Natural also argues that the Commission's disallowance of costs in this case is inconsistent with Commission decisions allowing recovery of costs for unsuccessful pipeline storage projects, dry holes drilled by natural gas producers, and unsuccessful electrical generation projects.[13]

In *Southern Natural Gas Co.*, 29 F.P.C. 323 (1963), the Commission permitted a natural gas company to include the cost of failed gas storage projects in its cost of service. The Commission commented that "the search for storage is an activity properly related to Southern's pipeline operations."

---

11. *Permian Basin* also directs attention to two other inquiries: whether the Commission has "abused or exceeded its authority," 390 U.S. at 791, 88 S.Ct. at 1373; and whether, considering "the manner in which the Commission has employed the methods of regulation which it has itself selected," "each of the order's essential elements is supported by substantial evidence," *id.* at 792, 88 S.Ct. at 1373. For the reasons stated generally in this opinion, we conclude that the Commission's order satisfies these standards.

12. *But cf. supra* note 8.

13. Natural raises no claim founded on § 4(b) of the Natural Gas Act, 15 U.S.C. § 717c(b), which prohibits certain discriminatory practices by natural gas companies. Natural's claim is simply that the Commission acted irrationally by treating similar situations differently.

Id. at 331; *see also Northern Natural Gas Co.*, 45 F.P.C. 1050 (1971) (permitting utility to recover costs of abandoned storage project over five years). The Commission has explained that it permitted amortization of losses on these storage projects because the projects "represented an effort on behalf of the companies to improve the quality and quantity of service systemwide. These were not individual projects of a short duration intended for the benefit of a small group of customers to meet a special service requirement." *Tennessee Gas Pipeline Co.*, 48 F.P.C. 149, 159 (1972), *aff'd*, 487 F.2d 1189 (D.C.Cir. 1978). Natural asserts that its failed gas supply projects were also efforts "to improve the quality and quantity of service system-wide." The Commission replies that it treats expenses for storage projects as "recurring costs associated with a continuing search for storage," rather than "nonrecurring costs associated with an unsuccessful project." FERC Br. at 16 (emphasis deleted); *cf. Southern Natural Gas*, 29 F.P.C. at 331-32 (suggesting that storage costs at issue were properly regarded as recurring).

In essence, the Commission treats the expenses of failed storage projects as a kind of recurring operating expense. Pipelines must have storage facilities, and efforts to find and secure those facilities are essential to maintaining the ordinary equipment of a pipeline company. Production activities are fundamentally different. It may be prudent and even necessary for pipelines to enter the production business, as Natural did in the three ventures at issue here, if the pipeline's suppliers appear unable to meet future needs of the pipelines' customers. But these production activities are not the normal activity of a pipeline seeking to maintain its physical plant and equipment; they are the normal activity of a producer, to which quite different rules apply. Natural has offered no reason why a pipeline should not be treated like other gas producers when the pipeline attempts to act as a gas producer.

Next, Natural points out that the Commission has allowed gas producers to recoup expenses incurred in unsuc-

cessful exploration efforts through the producers' cost of service. *See, e.g., El Paso Natural Gas Co.*, 22 F.P.C. 659, 665-65 (1959). If the cost of drilling a dry well can be included in the producers' cost of service and thus in rates for gas sold, Natural argues that it should be able to recover the cost of the three gas supply projects at issue here.

We believe, however, that the failed projects in this case are sufficiently unlike dry wells so that the Commission could reasonably treat the two situations differently. In the dry wells cases, the Commission has suggested that dry wells are a nearly inevitable result of efforts to find and develop new mineral deposits of natural gas. For that reason,

> [t]he gas consumer must pay rates sufficient, among other things, not only to amortize the cost of unsuccessful past drilling which makes present service possible, but also [to support] the current losses and other expenditures incurred in an effort to replace the gas currently being produced and consumed and [to] continue service in the future.

Phillips Petroleum Co. 24 F.P.C. 537, 559 (1960), *aff'd sub nom. Wisconsin* v. *Federal Power Comm'n*, 303 F.2d 380 (D.C.Cir. 1961), *aff'd*, 373 U.S. 294, 83 S.Ct. 1266, 10 L.Ed.2d 357 (1963). The Commission has thus viewed conventional efforts to find new natural gas as a bundle: it has not required wholly different treatment of failed and successful wells, but instead views the cost of dry wells as an unavoidable operating expense if new productive wells are to be found. The costs of dry wells are then recovered from revenue for gas from productive wells, which the Commission views as revenue from the same general "project."

The exotic technologies involved in SNG and LNG plants like the Dunn County and Kalingas projects are, the Commission believes, qualitatively different from dry wells. Lost investment in such plants is not an inevitable result of closely related activities that do produce natural gas for consumers. The Gas Arctic pipeline, too, was an uncertain enter-

prise that ended at an early stage in denial of a Commission certificate and thus in no gas. The Commission plausibly viewed these three projects as unusually risky ventures that were really distinct programs to supplement conventional gas sources, rather than viewing them as unsuccessful aspects of a general exploration program that did produce some gas for consumers. The failure of the three projects involved in this case was total, and from the outset the potential benefit to consumers from them was, as the Commission commented, remote and uncertain. *See* FERC Op. at 61,379-81. In contrast, the Commission has suggested that expenses for dry wells are integrally bound up with expenses for successful wells. The Commission could reasonably find that money Natural lost on its three projects, unlike money lost on dry wells, was not closely enough tied to any succesful exploration efforts to justify cost of service treatment.

Finally, Natural argues that the Commission has allowed electrical utilities to recover costs similar to those involved here, while irrationally denying Natural any recovery. Specifically, Natural notes that the Commission has permitted electrical utilities to amortize prudently incurred expenses from unsuccessful generation projects, and to recover those amortized expenses through the utility's cost of service. The Commission has not, however, allowed inclusion of these expenses in rate base. *See New England Power Co.*, 8 F.E.R.C. ¶ 61,054 (1979), *aff'd sub nom. NEPCO Mun. Rate Comm. v. FERC*, 668 F.2d 1327 (D.C.Cir.1981), *cert. denied*, 457 U.S. 1117, 102 S.Ct. 2928, 73 L.Ed.2d 1329 (1982). *See generally* Awerbuch & Freireich, *Nuclear Cancellations: Economic and Legal Bases for Allocating Losses*, in Award Papers in Public Utility Economics and Regulation 325, 340-44 (1982). According to Natural, the three failed gas supply projects in this case are comparable to the failed generation projects for which electrical utilities have recovered their costs. If electrical utilities may charge ratepayers for their failed efforts to develop new supplies of energy, Natural maintains that it must be allowed to do so as well.

The Commission offered two basic reasons for treating electrical utilities and natural gas companies differently. First, it pointed out that the statutory schemes governing electrical and natural gas utilities vary somewhat. Second, and more fundamentally, the Commission suggested that allocating the risk of failure for the projects involved in this case is a different policymaking problem than allocating the risk of failure for electrical plants.

The Commission identified two differences between the Federal Power Act and the Natural Gas Act that, in its view, supported the result in this case. First, the Commission noted that a natural gas company must obtain a certificate of public convenience and necessity before the company begins a gas project subject to the Commission's authority. [14] The Commission commented that "[t]his fact alone undoubtedly helps to explain the Commission's historic reluctance to allow pipelines to recover from ratepayers amounts lost in projects which were either ineligible for a certificate or, if eligible, did not receive a certificate." FERC Op. at 61,380. By contrast, the Commission has no authority to rule on electrical generation projects before they are constructed. This rationale supports the Commission's different treatment of expenses from

---

14. Section 7(c) of the Natural Gas Act, 15 U.S.C. § 717f(c), provides that "natural-gas compan[ies]" and "person[s] which will be a natural-gas company upon completion of any proposed construction or extension" may not engage in the transportation or sale of natural gas subject to the Commission's jurisdiction, undertake construction of facilities for those activities, or acquire or operate any such facilities, without a certificate of public convenience and necessity from the Commission. A "[n]atural-gas company" is "a person engaged in the transportation of natural gas in interstate commerce, or the sale in interstate commerce of such gas for resale." *Id.* § 2(6), 15 U.S.C. § 717a(6). The Commission has jurisdiction over "the transportation of natural gas in interstate commerce, . . . the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and . . . natural-gas companies engaged in such transportation or sale." *Id.* § 1(b), 15 U.S.C. § 717(b). The Commission does not have jurisdiction over certain local and state-regulated transactions in natural gas and facilities used in those transactions. *See id.* § 1(b)-(c), 15 U.S.C. § 717(b)-(c).

the Gas Arctic project and expenses from failed generation projects in a straightforward way. The pipeline planned by project participants could not be constructed without Commission review, and in fact all the money Natural lost was spent in unsuccessful pursuit of a certificate. Because the Commission has no certificate jurisdiction over electrical utilities, there is obviously no direct analogue in the electrical industry to money spent on a failed application for a certificate.

Next, the Commission noted that it lacked certificate jurisdiction over the Dunn County and Kalingas projects, and that if Dunn County SNG had been sold without commingling it with other natural gas and Kalingas LNG had been sold on foreign markets, the Commission would also have lacked authority to regulate rates for the gas produced. Ratepayers subject to the Commissoin's jurisdiction should not, in the Commission's view, ordinarily pay to develop supplies that might ultimately be delivered to ratepayers who purchase gas at unregulated prices. Electricity sold domestically by investor-owned utilities is always subject to rate regulation, either by the Commission or by the states. Ratepayers paying regulated prices thus always reap the benefits of successful generation projects. For that reason, the Commission is willing to impose a share of the risk of failure on federally regulated ratepayers by including in rates part of the cost of facilities intended to benefit them. But Natural could legally have sold SNG from the Dunn County project and LNG from the Kalingas projects at prices subject to no federal or state regulation. If price regulation might not contain the utility's potential profits from the endeavors, so, in the Commission's view, price regulation should not be used to protect the utility from the possibility of loss.

Natural replies that it always intended to sell any gas produced at the Dunn County and Kalingas projects to jurisdictional ratepayers. Even assuming that Natural's account of its intentions is correct, we think the Commission's argument retains some force. As the facts of this case demon-

strate, market changes can easily disrupt the plans of natural gas companies. Ratepayers paying regulated electricity prices were virtually certain to receive any electricity produced by failed generation facilities, while the likelihood that jurisdictional ratepayers would receive gas from the Dunn County and Kalingas projects depended on plans that might conceivably have changed. [15]

The Commission did not, however, rely principally on these statutory differences to distinguish failed electrical generation facilities from the Dunn County and Kalingas projects. Instead, the Commission suggested that those two projects were "highly speculative and any potential benefit to ratepayers was remote and uncertain." FERC Op. at 61,381. That conclusion is enough to support the Commission's refusal to follow the electricity cases in this very different context.

---

15. According to Natural, the Commission's concern that jurisdictional ratepayers might not have benefited from the Dunn County and Kalingas projects, even if they were successful, is unsupported by substantial evidence. The Commission, however, did not conclude that jurisdictional ratepayers probably would not have benefited; it found only that they might conceivably not have benefited. The Commission's concern that this outcome was possible, even if it may have been unlikely, is supported by substantial evidence.

Natural also criticizes the Commmission's suggestion that natural gas companies are compensated through their rate of return for entrepreneurial risks, such as the risk that gas supply projects will entirely fail. *See* FERC Op. at 61,379. Specifically, Natural argues that the Commission established its rate of return without considering this risk. However, the Commission never claimed that Natural's rate of return included a particular allowance for the risk that these three projects would fail. The Commission merely pointed out that rates of return are set with the knowledge that the risk of losses generally similar to those at issue here falls on the investors. Natural has said nothing to blunt that argument. Moreover, Natural can hardly have assumed in light of the Commission precedents we discuss, that it would be allowed to recoup the expenses of these three projects through its cost of service. Thus, if Natural believed that its approved rate of return was inadequate in light of its losses on the projects, it should have so stated to the Commission in the separate proceeding to set Natural's rate of return.

[4] The real gist of Natural's argument is that the Commission must logically adopt a single general policy for the natural gas and electrical industries governing recovery of money lost in abandoned supply projects. We think that suggestion fails to take account of the complex policy questions that are relevent in determining the appropriate treatment of these losses. As the Commission has recognized, money lost on abandoned projects, if not recovered through a utility's cost of service or rate base, ultimately comes from the rate of return allowed the utility. Charging losses against the rate of return in this way results in at least a short-term loss to investors, because earned surplus is reduced. However, as investors become aware that they bear the risk of losses from abandoned projects, they are likely to demand compensation for the risk by increasing the cost of capital to the utility. The cost of capital — that is, the return demanded by investors — is in turn eventually paid by ratepayers as a higher rate of return. Thus, the long-term burden of these losses, according to the Commission, eventually falls on ratepayers. "[I]f rate of return is required to be sufficiently high . . . to attract capital, the risk of [abandonment] losses must be borne by ratepayers either directly (through cost of service) or indirectly (through rate of return)." *New England Power Co.*, 8 F.E.R.C. at 61,177.

Given this complicated economic picture, the question of how to treat abandonment losses is a most involved one. In this case, for example, the Commission determined that the losses involved were proportionately small. *See* FERC Op. at 61,381. That finding suggests that charging the losses to investors may not noticeably increase investor risk and thus may not significantly alter the return investors demand.[16]

---

16. In the past, the Commission has not based its general policy of denying natural gas companies recovery of expenses for failed gas supply projects on the small amounts of the losses. In this case, however, we do not review that policy in all of its possible applications; we review the reasonableness of its application to the facts before us. The Commission argued that the relatively small losses involved here supported its refusal to depart from its established policy, and we believe that view is reasonable.

More fundamentally, the Commission evidently believed that the exotic SNG and LNG technologies involved in these projects were unproven and radically different from orthodox methods of obtaining and processing natural gas. Natural gas is conventionally obtained as a gas from mineral deposits, unlike SNG; and it is conventionally transported as a gas, without the elaborate cooling and liquefaction treatment required to protect LNG. SNG and LNG facilities can be seen as generically different from ordinary industry operations and thus as creating quite different risks for investors and ratepayers.

[5] We think the Commission could reasonably find that SNG and LNG facilities have no analogues in the electrical industry. Failed generation facilities may, of course, involve highly advanced technology, such as nuclear reactors. But Natural has not shown that its Dunn County and Kalingas projects were, when undertaken, as likely to be completed successfully and to benefit ratepayers as the failed electrical plans for which the Commission has permitted amortization. Even if it had, we believe that in setting rates within a just and reasonable range, the Commission may consider what future activities it wishes to encourage. The Commission could, for example, believe that the public interest in developing SNG and LNG facilities is more remote and doubtful than the public interest in developing innovative sources of electricity.[17] If so, the Commission could shift some of the risk that a generation facility might fail from investors to ratepayers, while requiring shareholders to bear the initial risk that an SNG or LNG facility might fail. *See generally* Avery, *The Cost of Nuclear Accidents and Abandonments in Ratemaking*, Pub.Util.Fort., Nov. 8, 1979, at 17, 21-22 (discussing policy questions involved in allocation of risk when utility plant fails). In short, the Commission could have believed that failed SNG and LNG facilities are unlike the failed electrical

17. *See* ALJ Op. at 65,229 ("the coal gasification process is seen as a new and unconventional source of gas, yet to be proved and found adaptable to the gas industry").

facilities for which amortization has been allowed, and consequently could rationally have treated these different cases differently.

C. *The Commission's Suggestion of a Future Prudence Standard*

[6] In its opinion, the Commission suggested that it might in the future apply a prudence test to failed natural gas supply projects, and it explained what the elements of such a test would be. The Commission also, however, noted that it would not apply the test to the projects at issue in this case and concluded that those projects would not have met the test in any event. Natural requested rehearing before the Commission, claiming among other things that the Commission had failed to give Natural an opportunity to show that its projects satisfied the proposed prudence test formulated by the Commission. In its opinion denying rehearing, the Commission stated that it "did not adopt a new prudence standard [in its previous opinion]; it merely held that the issue would be reconsidered in future cases and outlined basic ground rules which would apply in formulating any future prudence standard." *Natural Gas Pipeline Co. of Am.*, 28 F.E.R.C. ¶ 61,020 at 61,038-39 (1984). The Commission's characterization of its earlier opinion is entirely accurate. Natural cannot claim it was unfairly surprised by announcement of a proposed new standard when the Commission would not in any event have applied that standard to the projects at issue here.

CONCLUSION

The Commission has long held that a natural gas company may not include expenditures for gas supply projects that never produce any gas in its cost of service. We find that the Commission's enforcement of that policy in this case was reasonable. The petition for review is accordingly

Denied.

[¶ 61,020]

Natural Gas Pipeline Company of America, Docket No. RP78-78-013 (Abandoned Projects)

Opinion No. 218-A; Opinion and Order Denying Rehearing

(Issued July 5, 1984)

Before Commissioners: Raymond J. O'Connor, Chairman; Georgiana Sheldon, A. G. Sousa and Oliver G. Richard III.

[Note: Opinion No. 218 affirming in part and modifying in part Initial Decision, issued May 7, 1984, appears at 27 FERC ¶ 61,201.]

On June 6, 1984, Natural Gas Pipeline Company of America filed a request for rehearing of Commission Opinion No. 218, issued in the above-captioned proceeding on May 7, 1984. In Opinion No. 218, the Commission denied Natural's request to amortize losses incurred in several unsuccessful gas supply projects.

In its request for rehearing, Natural argues that the Commission's decision in Opinion No. 218 (1) consitutes an unwise policy since it discourages pipelines from taking steps to deal with supply problems which may arise, (2) is inconsistent with other cases decided under the Natural Gas Act, (3) erroneously concludes that the risk of failure of gas supply projects can reasonably be compensated for by the pipeline's rate of return, (4) fails adequately to justify differences in Commission amortization policies under the Natural Gas and Federal Power Acts, and (5) misapplies the prudency test allegedly adopted in the Opinion.

Upon review of this matter, we find that Natural has not presented grounds justifying modification of Opinion 218. The objections raised by Natural represent for the most part restatements of arguments previously made and rejected by the Commission in issuing Opinion 218. Natural has presented no new facts or arguments which would justify a differ-

ent result. Disallowance of costs associated with Natural's unsuccessful supply projects is consistent with established Commission policy and with numerous prior cases cited in Opinion 218.

With regard to the prudence issue, Natural argues that the suggested prudence test set forth at page 9 of Opinion 218 should not be applied to Natural because "its enunciation has occurred after the fact." Natural also argues, however, that if the test were applied in this case, the projects in question would meet the test.

Natural's arguments are without merit. The Commission did not adopt a new prudence standard in Opinion 218; it merely held that the issue would be reconsidered in future cases and outlined basic ground rules which would apply in formulating any future prudence standard. The Commission also held that a prudence standard would not be applied to preliminary projects such as Dunn County and Kalingas in any event, but might be applied to "projects which have been carried beyond the stage of preliminary survey and investigation and where the pipeline's investments are proportionately greater." (Opinion 218, p. 9.) Furthermore, any prudence standard which might be developed in future cases would not apply to the Gas Arctic project. The Commission has ruled in prior cases as well as in this case that losses sustained in that project may not be recovered by the participating pipelines from their ratepayers. The Gas Arctic issue is closed.

The Commission orders:

Natural's request for rehearing of Opinion No. 218 is denied.

[¶ 61,201]

Natural Gas Pipeline Company of America, Docket No. RP78-78-001 (Abandoned Projects)

Opinion No. 218; Opinion and Order Affirming in Part and Modifying in Part Initial Decision

(Issued May 7, 1984)

Before Commissioners: Raymond J. O'Connor, Chairman; Georgiana Sheldon, J. David Hughes, A. G. Sousa and Oliver G. Richard III.

[Note: Presiding Administrative Law Judge's Initial Decision, issued December 20, 1979, appears at 9 FERC ¶ 63,059.]

Appearances

Joseph M. Wells, Paul E. Goldstein and *Leslie Recht* for Natural Gas Pipeline Company of America

James Hinchliff for the Peoples Gas Light & Coke Company, North Shore Gas Company

J. Stanley Stroud, Justin Stanley, Robert A. Helman and *Wendell H. Adair* for Northern Illinois Gas Company

Joseph T. Morrow for Northern Indiana Public Service Company

David W. Kruger for Foster Forbes Glass Company

Steven Gerhart for Iowa Electric Light and Power Company

Charles A. Crampton and *E. J. Hartman* for Iowa-Illinois Gas and Electric Company

Michael K. McCabe for Iowa Power and Light Company

John Rudolph and *James H. Wuller* for Mississippi River Transmission Corporation

James Blasiak and *William A. Williams* for the staff of the Federal Energy Regulatory Commission

[Opinion No. 218 Text]

On June 30, 1978, Natural Gas Pipeline Company of America (Natural) filed proposed changes to its FERC Gas Tariff which, if approved, would increase its jurisdictional revenues by $53 million annually, or approximately four percent. On July 28, 1978, the Commission suspended the proposed higher rates and set the matter for hearing. Most of the issues pertinent to the filing were resolved in an uncontested settlement approved by the Commission in a letter order issued on October 4, 1979 [9 FERC ¶ 62,005]. Several issues involving costs associated with tax normalization, amortization of several unsuccessful and abandoned nontraditional gas supply projects, and onshore separation of liquids, remained unresolved by the settlement. At Natural's request, the tax normalization question was removed from this proceeding and consolidated with Docket No. RP77-98 for separate hearing and decision. [1] Following hearing, the administrative law judge, on December 20, 1979, issued his initial decision on the remaining issues. The liquids separation issue was subsequently resolved by companion settlements in several of Natural's rate dockets including RP78-78 (23 FERC ¶ 63,003) and *High Island Offshore System* (HIOS) Docket No. RP81-18-007. The HIOS settlement was approved by letter order issued February 24, 1984 [26 FERC ¶ 61,302]. A settlement order in RP78-78, *et al.* will be issued separately. The only issues remaining to be decided in this proceeding involve Natural's proposed amortization of costs

1. The tax normalization issue was decided by Opinion No. 108, 13 FERC ¶ 61,266 (1980); Opinion No. 108-A, 21 FERC ¶ 61,119 (1982); Opinion No. 108-B, 26 FERC ¶ 61,047 (1984). The Opinion No. 108 series is currently pending judicial review in the U.S. Court of Appeals for the D.C. Circuit.

associated with abandoned gas supply projects. We proceed to decide those issues. [2]

Abandoned Gas Supply Projects

Natural seeks to amortize over a five year period on a dollar-for-dollar basis some $13 million of costs which it incurred in connection with three unsuccessful gas supply projects. Natural does not seek rate base treatment or carrying charges for unamortized costs. It will be helpful to briefly describe the three projects.

(1) *Dunn County SNG Project.* Natural considered building a coal gasification facility in Dunn County, North Dakota which would initially produce 250 MMcf of gas per day. In 1973-74 Natural acquired certain coal leases and an option to purchase property in North Dakota necessary for the Dunn County project. Natural engaged consultants to prepare various studies required to develop an "environmental assessment report" required for state and federal regulatory applications. By 1976 the project was suspended because Natural was denied an essential state water permit and because additional costly environmental studies were required due to amendments to the Clean Air Act and the subsequent enactment of the Surface Mining Control and Reclamation Act. Natural's costs associated with the Dunn County project totalled approximately $11.7 million.

2. The issue of amortization of abandoned project costs in Natural's succeeding rate Docket Nos. RP80-107, RP81-49, and RP82-62 was settled on the basis that Natural's claims would be determined by the Commission's decision in this case.

Natural seeks in this proceeding to amortize approximately $1.5 million of these costs. [3]

(2) *Kalingas LNG Project.* In 1975 Natural joined a consortium of companies organized to produce and liquefy natural gas from a field offshore from Iran having potential reserves of 180 Tcf. At that time, according to Natural, Kalingas offered the only available source of LNG for delivery in the early 1980's. (Deliveries were scheduled to commence as early as 1982.) Natural paid $4.5 million to Chicago Bridge and Iron Company for the right to buy a 5 percent working interest in Kalingas. The 5 percent working interest would have given Natural the right to purchase 400 MMcf per day of LNG production from Kalingas. Natural discontinued its participation and forfeited its investment in the Kalingas project in 1977 because of severe cost escalations resulting from the need for a larger financial commitment and because the emergence of alternative and more attractive supply sources.

(3) *Gas Arctic Project.* During the period 1971 through 1977, in an effort to obtain certificate authorization to transport gas from the Prudhoe Bay area of Alaska to the lower 48 United States, Natural participated as a member of the Gas Arctic Northwest Project Study Group (Gas Arctic) to study the engineering, environmental, legal and economic issues involved in such an enterprise. Natural's unrecovered contribution to the project is approximately $6.7 million. A competing consortium of pipelines, Alaskan Northwest Natural Gas Transportation Company, was ultimately granted

---

3. It appears that Natural initially transferred a substantial portion of the Dunn County costs to the Great Plains SNG project, located in Mercer County, North Dakota, in which Natural is a sponsor and partner along with several other pipelines. However, Natural later sought through amortization to recover these costs in its own rates in Docket Nos. RP80-107, RP81-49, RP82-62 and RP83-68. This case deals only with the claimed $1.5 million, which is attributable to environmental studies.

authorization to build the Alaskan gas pipeline. Gas Arctic is in the process of liquidation.

In his initial decision, the presiding judge considered the facts and cicumstances of each of the projects and ruled on them individually. He found that the gas supply initiatives represented by the projects were required in light of Natural's deteriorating gas supply situation. He approved amortization of the Dunn County project expenses. He ruled that the Gas Arctic expenses should be considered in a rulemaking proceeding involving all of the pipelines which participated in the project; he denied amortization of Natural's Gas Arctic expenditures in this proceeding. Finally, the judge denied Natural's Kalingas expenses, except for some $245,000 of administrative expenses, which he allowed. The judge's decision was based on his conclusion that the Kalingas project was analogous to a foreign advance payment and that the Commission's consistent policy has been to deny recovery by pipelines of costs associated with foreign advance payments.

Briefs on and opposing exceptions to the initial decision were filed by Natural and the staff. Natural argues that in ruling on its request for amortization of losses on these three projects the proper legal test for the Commission to apply is whether the costs were prudently incurred and whether the projects represented a valid effort to improve the quality and quantity on service system-wide. If these conditions are met, then amortization should be permitted. The Commission staff, which is the only party opposing amortization, argues that while prudence is a "threshold" question and the "lowest common denominator" of all possible tests, the proper test to be applied to this case is the so-called "used and useful" test which, according to the staff, would require that a project be successfully completed, that is, actually constructed and placed in service, before any orm of recovery through rates is permitted. Application of this standard would result in denial of Natural's amortization request since each of the projects was unsuccessful.

In allowing amortization of the Dunn County costs, the judge reviewed a number of relevant Commission decisions under both the Natural Gas and Federal Power Acts. Cases cited by the judge include *Michigan Wisconsin Pipe Line Company*, 51 FPC 2408 (1974). There the FPC disallowed the pipeline's claim for delay rental payments for coal associated with a proposed coal gasification program. In rejecting this claim, the FPC stated that "there is not adequate assurance that Mich-Wis will ever actually mine the coal or gasify it. We believe that the possible benefit is too far removed from the costs proposed to be borne by the natural gas consumer." 51 FPC at 2411. See also *Natural Gas Pipeline Company of America*, Opinion No. 782, 56 FPC 2976, 2980-81 (1976); *Southern Natural Gas Company*. 52 FPC 658 and 52 FPC 1135 (1974). In *Transcontinental Gas Pipe Line Corporation*, Opinion Nos. 801 and 801-A, 58 FPC 2038 and 59 FPC 1237 (1977), *aff'd* 606 F.2d 1044 (D.C. Cir. 1979), the FPC denied the pipeline's claim both for rate base treatment and amortization of costs associated with several proposed SNG projects. In *Northern Natural Gas Company*, Opinion Nos. 14 and 14-A, 3 FERC ¶ 61,131 and 4 FERC ¶ 61,312 (1978), this Commission disallowed the pipeline's claim for recovery of costs for "studies dealing with engineering and design research, environmental matters, plant site evaluation and coal reserve evaluation to determine the viability and practicality of proceeding with further development of a coal

gasification program."[4] Accord, *Texas Eastern Transmission Corporation*, 58 FPC 2412 (1977).

The judge considered other cases in which the Commission has permitted recovery of unsuccessful expenditures. For example, the Commission has allowed pipelines to recover the cost of failed gas storage projects. *Southern Natural Gas Company*, Opinion No. 379, 29 FPC 323 (1963); *Northern Natural Gas Company*, 45 FPC 1050 (1971). The Commission has also permitted gas producers and pipelines to recoup the cost of dry holes. *Phillips Petroleum Company*, 24 FPC 537 (1960); *El Paso Natural Gas Company*, 22 FPC 659 (1959); *Panhandle Eastern Pipe Line Company*, 25 FPC 787 (1961). The Commission has also permitted electric utilities to amortize and thereby recover costs associated with abandoned or unsuccessful electric supply projects. *New England Power Company*, Opinion No. 49, 8 FERC ¶ 61,054 (1979); *Southern California Edision Company*, Opinion No. 62,8 FERC ¶ 61,198 (1979); *Union Electric Company*, 8 FERC ¶ 63,026 (1979), *aff'd* Opinion No. 94, 12 FERC ¶ 61,239 (1980).

The judge concluded, in effect, that the cases dealing with synthetic natural gas were anomalous and created a "dichotomy" in Commission policies applicable to abandoned or unsuccessful projects. While aware of the earlier

---

4. Northern Natural originally claimed these costs on the basis they constituted research and development (R&D) expenditures which were recoverable under the Commission's then-existing definition of R&D. *See* FPC Order No. 483, 49 FPC 1054 (1973). the FPC in Opinion No. 14 determined that the studies in question did not constitute R&D. The FPC further denied Northern Natural's alternative request for amortization as non-R&D costs. Amortization was granted as to certain amounts spent by Northern Natural on a "coal slagging gassifier" project. This project was found to constitute R&D under order No. 483. The R&D regulations were subsequently amended to include demonstration plants within the definition of R&D. The new category is referred to as RD&D *See* Order No. 566, 58 FPC 2238 (1977). The new regulations provide for advance approval by the Commission of proposed RD&D projects. The projects at issue in this proceeding were not claimed by Natural as R&D or RD&D and no advance approval was obtained.

cases, the judge concluded that the Commission had changed its policy relative to coal gas projects in Opinion No. 69, *Great Plains Gasification Associates, et al.*, 9 FERC ¶ 61,221 (1979). In that case, the Commission approved the Great Plains coal gasification project in Mercer County, North Dakota as a demonstration plant under its RD&D regulations and in doing so adopted proposals guaranteeing recovery of costs by the project's sponsors even in the event of failure. The judge also relies on Opinion No. 728, *Transwestern Pipeline Company, et al.*, 53 FPC 1287 (1975). The judge interprets that opinion as having guaranteed coal gas project applicants full recovery of costs whether or not the project was successful. Based on these considerations the judge held that "gas supply projects, unconventional or not, when begun in good faith and in strict prudence as efforts to relieve the nation's gas shortage, may be recognized in the pipeline's rates to the limited extent of amortizing their bare, out-of-pocket costs in the event of particular failure." 9 FERC at p. 65,230.

Upon review of this matter, we are unable to agree with the judge. Commission precedent as well as sound policy considerations dictate that the Dunn County expenses be disallowed. As previously noted, costs associated with abandoned SNG projects have been disallowed by the Commission in numerous previous cases. The judge's reliance on *Great Plains* is misplaced. The Great Plains project, unlike Natural's Dunn County project, was approved as a demonstration plant pursuant to the Commission's RD&D regulations, 18 C.F.R. 154.38(d)(5) and therefore does not represent a departure from cases which disallow SNG costs which are not R&D. More significantly, Opinion No. 69 was set aside on judicial review on grounds this Commission lacked statutory authority to provide for recoupment of SNG project costs prior to commencement of service. *Office of Consumers'*

Counsel v. *F.E.R.C.* 655 F.2d 1132 (D.C.Cir. 1980).[5] The judge's interpretation of Opinion No. 728 as guaranteeing recovery of SNG costs in the event of failure is likewise in error. The FPC in Opinion No. 728 provided for recovery by the sponsors of their costs only out of project revenues once SNG was produced and sold to the pipeline. There was no guarantee of cost recovery in the event of failure.[6] Nor do we believe the cases allowing dry hole costs support the judge's conclusion. The premise underlying these cases is similar to that of the SNG cases, namely, costs must be recovered, if at all, out of project revenues. If there is no production, there is no recoupment of costs. The Commission has expressly held that production of SNG by pipelines is analagous to production of natural gas by independent producers and that "the same shareholder risk should apply." 58 FPC at 2044.

A review of the above-noted NGA cases reveals that costs associated with unsuccessful gas supply projects have been disallowed in instances where the project is non-jurisdictional (or, if jurisdictional, has not received a certificate or other form of advance approval such as RD&D costs). The fact of non-jurisdictionality or non-certification, however, is a relevant but not a controlling factor. *See* 58 FPC at 2042; 4 FERC at p. 61,705. Rather, these costs have been disallowed because the projects were found to be speculative and uncertain, remote in time, and without benefit to ratepayers. These projects have been held to constitute risks which should properly be borne by shareholders rather than ratepayers and which should be compensated by means of the pipeline's

---

5. The Great Plains project was later approved based on a settlement which provided for recoupment of project costs out of project revenues. *See* Opinion No. 119, 15 FERC ¶ 61,106 (1981).

6. The so-called WESCO Project approved in Opinion No. 728 was not successful. Transwestern Pipeline Company is seeking amortization of amounts lost on the project. *See* inital decision issued March 13, 1981 in Docket No. RP78-88, 14 FERC ¶ 63,065.

allowed rate of return rather than by means of a specific allowance in the cost of service. 4 FERC at p 61,706.[7]

Natural argues that the Commission's policies under the Natural Gas and Federal Powers Acts are inconsistent. Natural relies on several cases decided under the Federal Power Act in which the Commission has allowed electric utilities to amortize the costs of unsuccessful electric power projects. Opinion Nos. 49, 62, and 94, *supra; Southern California Edison Company*, Opinion No. 821, 59 .FPC 2167 (1977). While there is a difference in Commission policy as between gas and electric projects, that difference is due in part to differences between the statutes. Section 7(c) of the Natural Gas Act provides that no natural gas pipeline may engage in the transportation or sale of natural gas subject to the Commission's jurisdiction, or construct, extend, acquire or operate any facilities for jurisdictional services unless that pipeline obtains from the Commission a certificate of public convenience and necessity. Thus before any jurisdictional project can be undertaken, a pipeline must file for a certificate. The Commission reviews and evaluates the project and if it is found to be required by the public convenience and necessity, a certificate is granted, subject to pertinent condi-

---

7. In certain cases disallowance of costs has been based on the so-called "used and useful" theory under which costs must be associated with facilities which are used or useful in rendering service in order to be included in the pipeline's rate base. *See* 59 FPC at 1239. The used and useful test is a rule-of-thumb applied to determine rate base eligibility. It is not properly applicable to or dispositive of the question of whether amortization of particular costs should be permitted.

tions if found to be necessary.[8] This fact undoubtedly helps to explain the Commission's historic reluctance to allow pipelines to recover from ratepayers amounts lost in projects which were either ineligible for a certificate or, if eligible, did not receive a certificate. The Commission has been particularly reluctant to allow amortization of failed SNG projects since they are non-jurisdictional. *El Paso Natural Gas Company*, Opinion No. 663, 50 FPC 651 (1973). The Commission's concern is that a project is successful, the pipeline will stand beyond the reach of Commission authority and reap the benefits, while if it is unsuccessful, ratepayers will be saddled with the loss. *See* 58 FPC at 2042.[9] No such certifying authority exists under the Federal Power Act, and in electric cases the Commission has applied a prudence or prudent investment test in determining claims related to abandoned projects. Even so, Natural's argument is greatly overstated. A review of the electric precedents reveals that the projects for which amortization was approved were not comparable to speculative projects such as Dunn County. Furthermore, the sale of electric energy is subject to rate regulation either by the states or, in the case of sales or resale, by this Commission, whereas the sale of synthetic gas is non-jurisdictional and theefore not subject to regulation.

---

8. In certain cases involving major projects, the Commission, in issuing a certificate of public convenience and necessity, has established specific conditions governing the apportionment of risk between stockholders and ratepayers in the event the project ultimately fails. *See, e.g., Tennessee Gas Pipeline Company*, Opinion No. 624, 18 FPC 149 (1972); *Ozark Gas Transmission System*, Opinion No. 12, 16 FERC ¶ 61,099 (1981). *Trailblazer Pipeline Company*, Opinion No. 138, *et al.*, 18 FERC ¶ 61,244 (1982). No similar conditions have been prescribed for Natural's abandoned projects since none of the projects received a certificate. In one case (Dunn County) the project was nonjurisdictional, in another (Kalingas) no certificate application was made, and in the third (Gas Arctic) a certificate was applied for but not granted.

9. There is a question as to whether ratepayers can be made responsible for losses on failed SNG projects. *See Great Plains*, 655 F.2d at 1148. *But of P.U.C. of Colorado* v. *F.E.R.C.*, 660 F.2d 821 (D.C.Cir. 19871). It is unnecessary to reach that question here since we conclude Natural's claimed SNG costs must be disallowed.

It is superficially appealing to say that the prudence test should apply in all cases. But how would such a test be applied in the instant case considering the exceedingly preliminary nature of the claimed expenses? There can be no doubt that a critical gas shortage existed throughout the nation in the mid-1970's and that as a result pipelines began, of necessity, to consider a wide range of alternative gas sources such as those here at issue. There is no evidence that Natural acted unreasonably in investigating these alternatives. How could this Commission, some 10 years later, say that Natural's actions were unreasonable or imprudent? Yet this line of argument is too facile. See 4 FERC at p.61,705. While the existence of the gas shortage undoubtedly justifies Natural's actions in a corporate business sense, it does not justify imposing all of the resulting losses on consumers. While Natural is correct in arguing that there is a lack of complete consistency between the Commissions's amortization policies under the Natural Gas and Federal Power Acts, that fact is not decisive. To approve amortization here would result in a direct transfer of risk and related cost from Natural's shareholders to its ratepayers. It would require the ratepayers to bear the costs associated with this speculative project, from which they received no benefit and from which they might not have benefited even if the project had been successful. The Commission's policy applicable to failed gas supply projects is of long standing and has been consistently applied in numerous cases. The Commission's policy in this area is therefore well established. We have reviewed that policy in the course of deciding this case and have concluded that no changes are warranted. Accordingly, the Dunn County costs must be disallowed.

With regard to the Kalingas project, the judge disallowed the bulk of the $4.7 million of claimed costs based on the dual conclusions that such costs were analagous to foreign advance payments and the foreign advance payments have uniformly been denied rate treatment by the Commission, citing *Tennessee Gas Pipeline Company*, Opinion No. 769, 56 FPC 120 (1976). The judge characterized the Commission's objection

to foreign advance payments as being that "the prospect of betterment to the rate payers was and is entirely too remote for the consumers to be called upon to underwrite investments in gas abroad." 9 FERC at p.65,226. The judge did allow Natural to amortize $244,824 of administrative expenses associated with the project. Natural excepts to the disallowance of the base costs while the staff excepts to the allowance of administrative expenses.

Upon review of this matter, we conclude that the judge properly disallowed amortization of the Kalingas project costs. Much of what we have stated previously in connection with Natural's Dunn County project applies equally to the Kalingas project. Major aspects or components of the project such as the price of foreign LNG and the cost of shipment to the U.S. would have been nonjurisdictional, and those components which would have been jurisdictional (U.S. facilities and sales) did not receive a certificate. Like the Dunn County project, Kalingas was highly speculative and any potential benefit to consumers was remote and uncertain. Natural in fact never reached the point of investing in the project or becoming a participant in the project. The payment to Chicago Bridge and Iron merely gave it the right to purchase a 5 percent interest in the project. Natural never exercised that right. Under these circumstances, there is no basis to require gas consumers to assume responsibility for amounts lost on the project. As to the related administrative expenses, the allowance of this item is not supported on the record or by the judge's decision. The judge states only that these costs "are allowable and may be included as routine administrative expenses, the same as any other part of the cost of administration." 9 FERC at p.65,226. We fail to see why all costs associated with the Kalingas project, both direct and administrative, should not be treated the same. We have determined that the base costs of the Kalingas project must be disallowed and it follows that administrative or other similar costs associated with the project must likewise be disallowed.

While holding that the Dunn County and Kalingas costs must be disallowed consistent with established Commission policy, we do not foreclose reconsideration of the abondoned projects issue in future cases where projects have been carried beyond the stage of preliminary survey and investigation and where the pipeline's investments are proportionately greater. We do not necessarily reject the idea that a standard based on prudence between shareholders which would serve fairly to apportion the risk of loss on such projects between shareholders and ratepayers. However, as we stated previously, the mere existence of a gas shortage cannon be said automatically to render prudent any and all expenditures on alternative gas supply projects.

A pipeline claiming amortization of costs based on a standard of prudence should be prepared to demonstrate that it (rather than the corporate parent or corporate affiliates) was the source of funds expended, and that the project, if successful, would have benefited its customers and consumers. The pipeline should also be prepared to present detailed evidence concerning the degree of planning which went into the project as well as any assumptions which were made prior to the commitment of funds. In addition, the pipeline should present evidence concerning the factors which led to abandonment or failure of any project and actions taken to avoid or mitigate resulting losses. In summary, the record must contain evidence which would be sufficient to enable the Commission to determine the reasonableness and prudence of the projects and the pipeline's actions concerning them.

Finally, the judge determined that all claims for Gas Arctic costs should be considered in a single rulemaking proceding so that a uniform, consistent policy could be adopted which would apply to all of the original Gas Arctic participants. While we support the judge's goal of consistency, it is unnecessary to establish a separate rulemaking proceeding to deal with this cost item. Subsequent to the issuance of the initial decision, the Commission issued decisions in two cases involving claims by Gas Arctic participants

for approval to amortize costs incurred in the Gas Arctic project. *Columbia Gas Transmission Corporation*, Opinion No. 101, 13 FERC ¶ 61,102 (1980); *Michigan Wisconsin Pipe Line Company*, 13 FERC ¶ 61,254 (1980). In both cases, the claimed Gas Artic costs were disallowed.[10] In denying these costs the Commission in Opinion No. 101 stated as follows (mimeo p. 10):

> The project had become a viable proposal which was appropriate for a certificate application and for the corporate judgments which attend the decision to file that application. However, the Gas Arctic project did not receive the necessary certificate approvals. An alternative project was found to better serve the public convenience and necessity. The judgment was made that this alternative project would maximize consumer and ratepayers' benefits relative to the other project proposals, including the Gas Arctic project, and best serve the public interest.
>
> In this context, a judgment of benefit to ratepayers from Columbia's participation in the Gas Arctic project cannot be made. These expenses, which are neither RD&D in nature nor incurred in connection with a certificated project, are entrepreneurial in character and should not be recovered in rates. The pipeline's stockholders should bear the risk of non-recovery of expenses in cases where, as here, an alternative project is found to better serve the present and future public convenience and necessity. This treatment, which is part and parcel of an overall framework under the Natural Gas Act for rate treatment of expenditures

---

10. In both cases the pipelines were given the opportunity to recover their Gas Arctic expenses in the ongoing Alaskan Northwest proceeding in Docket No. CP78-123, *et al.* provided they could show the expenditures contributed to the successful project. The Commission subsequently disallowed all Gas Arctic expenses in the *Alaskan Northwest* proceeding. *See* 19 FERC ¶ 61,218 (1982).

incurred prior to the time a project becomes used and useful, properly balances ratepayer and stockholder interests and provides those incentives and disincentives in the certificate process which the Commission finds entirely appropriate.

For the same reasons stated by the Commission in Opinion No. 101, Natural's claim for amortization of Gas Arctic expenditures must be denied.

The Commission orders:

(A) The initial decision is affirmed in part and modified in part in accordance with the terms of this order.

(B) Within 75 days from the date of this order, Natural shall file revised rates and supporting data consistent with the terms of this order. However, if applications for rehearing are pending at the close of the 75 days period, the required filing shall be made within 30 days after the date in which the applications for rehearing are disposed of.

(C) Within 30 days following approval of the rates submitted pursuant to paragraph (B) above, Natural shall refund all amounts collected in excess of the approved rates together with interest calculated in accordance with section 35.19(a) of the Commission regulations. Within 10 days thereafter, Natural shall file a statement showing the amount of refunds and interest paid.

[¶ 63,059]

Natural Gas Pipeline Company of America, Docket No. RP78-78

Initial Decision on Pipeline Rate Filing

(Issued December 20, 1979)

[Note: Opinion No. 108 affirming in part and modifying in part Initial Decision was issued December 23, 1980, and appears at 13 FERC ¶ 61,266.]

TABLE OF CONTENTS

I. Nature and Summary . . . . . .
II. Procedural Status . . . . . .
III. The Pipe Line's Cost Incurred for Separation of Liquids . . . . . .
IV. Alternate Supply Programs — The Kalingas Project . . . . . .
V. The Arctic Gas Project . . . . . .
VI. The Coal Gas Project . . . . . .
VII. Order . . . . . .

Appearances

Joseph M. Wells, Paul E. Goldstein and *Leslie Recht* for Natural Gas Pipeline Company of America

James Hinchliff for The Peoples Gas Light & Coke Company, North Shore Gas Company

J. Stanley Stroud, Justin Stanley, Robert A. Helman and *Wennel H. Adair* for Northern Illinois Gas Company

Joseph T. Morrow for Northern Indiana Public Service Company

David W. Kruger for Foster Forbes Glass Company

Steven Gerhart for Iowa Electric Light and Power Company

Charles A. Crampton and *E. J. Hartman* for Iowa-Illinois Gas and Electric Company

Michael K. McCabe for Iowa Power and Light Company

John Rudolph and *James H. Wuller* for Mississippi River Transmission Corporation

James Blasiak and *William A. Williams* for the Staff of the Federal Energy Regulatory Commission

ELLIS, *Presiding Administrative Law Judge:*

I

Nature and Summary

This is a major rate case of a major pipeline, the Natural Gas Pipeline Company of America, serving the distributors in Chicago and the surrounding area. There were numerous questions, with many issues to be resolved; however, a settlement has been negotiated on all but three, and it has now received the Commission's blessing. Also, one of the three issues has been severed out and associated with another

docket for decision. The two remaining issues here decided relate to —

a) amortizing in the cost of service substantial outlays for three unsuccessful and abandoned projects for substitute or supplemental gas supply, and

b) claiming the costs incurred for the separation out of liquids entrained while the gas is in passage from its off-shore Gulf production points to the pipe line on the shore.

II

Procedural Status

Natural's rate filing was completed 17 months ago and assigned docket RP78-18. The revenue increase besought comes to $53 million, or just under four percent on the cost of service, which is based on the twelve months concluding with February, 1978. The Commission's hearing order of July 28, 1978, 4 FERC ¶ 61,089, granted intervention to eight distributors serving the residents of Illinois and surrounding states. The order reported that Natural's filing was motivated by the need to increase both the depreciation rate and the equity return, to meet higher costs of transportation of gas by others, and to meet certain income tax problems. The order summarily rejected a "tracking" provision for transportation costs paid, but left the issue open for hearing and for decision prospectively.

Ten more distributor intervenors entered the cause, also one industrial user, following which the parties met in November, January and February (all on the record) and on quite a number of other occasions informally, all for the purpose of arriving at a settlement. By February, it was announced that a settlement has been reached, except for the three reserved issues, one of which (tax normalization) was found to be recapitulated in another docket, RP77-98; hence, the Secretary's order of March 26, 1979 removed that issue

from this docket and consolidated it with RP77-98, 6 FERC ¶ 61,262.

The two remaining issues became the subject of considerable detailed testimony, mostly from the staff and from the company, all of which went to hearing in July. Briefs were filed in August and September, but only from the staff and from the company; none has appeared from any of the intervenors.

In the meantime, the final settlement was filed on all but those three issues and was certified to the Commission on August 28, 1979. The truncated settlement was approved by the Commission's letter-order of October 4, 1979, 9 FERC ¶ 62,005, so the new rates which went into effect at various dates last winter will be expected to be adjusted shortly to accord with the settlement, but subject to the rulings on the three reserved issues, when they shall become final.

III

The Pipe Line's Cost Incurred for Separation of Liquids

One of the three disputed elements of the cost of service reserved out of the settlement is a pipeline expenditure incurred for the separation of oil liquids out of the gas stream. It is stated in the disarming figure of $.43, but it turns out this is just over a million dollars per year added to the cost of service, and thus to the customers' bills. The $.43 is a monthly demand charge multiplied by the numbers of Mcf of the demand for the separation service. So, what it amounts to, assuming a steady flow throughout the year at full load factor, would seem to come to a little over 1.4 cents per Mcf of gas. But, of course, the background turns out to be quite complicated.

Natural, the great pipeline serving Chicago and other parts of the Midwest, buys a lot of gas at platforms offshore in the Gulf of Mexico, some of it a hundred miles or so from land. As it spews forth from the briny deep, the product is not only gas, but considerable amounts of liquid oil (which, for

present purposes, includes liquefiable portions of the gas which end up as oil for the oil company, not gas for the gas company).

Natural's purchase covers gas, not oil; the liquids are a valuable by-product, retained by the oil company, which is also the gas producer. (Or it may be the other way around, to some viewpoints, the oil or liquids may be the prime mineral and the gas sold merely the by-product.) To accomplish this sale of gas but not of oil, there is an initial separation process right on the offshore platform, all at the producer's expense, and this permits the testing and measuring of the actual gas sale and delivery which take place at that point, a process repeated once or twice later on. To bring the gas ashore (perhaps many miles), Natural employs a contractor known as HIOS, which turns out to be a partnership consisting of Natural and four or five other pipelines.

HIOS, as a transporter, files a tariff here, and its operations are themselves regulated and subject to Commission order. For a part of its service, HIOS itself employs certain subcontractors, and between them, the gas is brought ashore, but it does not travel alone. The oily liquids taken out of the gas at the platform are considerable in volume and value, hence are wanted by the producers. To get the liquids ashore, it is the customary arrangement for the liquids to be reinjected into the gas stream at the offshore facility, so that both commingled for the long trip to dry land, the transportation service procured from HIOS.

Finally, on shore, HIOS is required by Natural to separate out the liquids once more for redelivery to their ogiginal producer (the oil company). Quite separate from the transportation freight bill, HIOS' filed tariff charges Natural $.43 per month per Mcf of demand for the discrete function of separating out the liquids. It is that $.43 which amounts to an annual expenditure by Natural of just over a million dollars.

When that sum appears in Natural's cost of service, the FERC staff raises profound objection on the simple and

straightforward ground that the separation of the liquids is a function performed for and on behalf of the producers who realize the proceeds of the oil so separated. It is not done for the benefit of the gas consumers, and so the homes and businesses in Chicago that end up burning the gas should not find this cost in their monthly gas bill. No so, says Natural, its is part of their cost of doing business, they have to pay it, and so they are entitled to recover it. Their lies the rub; there arises the issue.

If this is all the case amounted to, the answer would be obvious—the oil is the property of the producers and they reap its avails. It is the producers who bear the expense of the initial separation offshore, and evidently they bear the expense of the transportation to the shore of the entrained oil; at least that is not undertaken to be charged to the gas customers. The final item—the $.43 demand for the re-separation of the liquids after their carriage ashore in the gas stream— is quite in the class with the origina separation of the liquids, their reinjection, and the transportion ashore, all of these functions being for the use, benefit and account of the producers; they are not for the use and benefit of the gas customer and there is no occasion for the charge to appear in the gas bill. So it appears on the surface, but there is more.

First, Natural invokes a straw man argument indeed, saying the 43§ charge is part of the filed, published tariff rate of HIOS as approved by an order here only last December. As a filed rate, it is one that Natural has no option but to pay. So, we are told, it is an expense of the gas business, and the Commission is required to permit Natural to recover its costs from the customers, even as it recovers the cost of gas and other expenses. Thus the "filed rate doctrine" enters an unaccustomed field.

Differing sharply with Natural, staff sees it not at all a question of assessing the burden between Natural's treasury and the gas customer. Rather, as staff perceives it, it is quite plain that Natural has to incur the expense since they have contracted with HIOS for the service. But Natural should get

their money back from the producers whose oil it is and who benefit from it, not from the gas customers who do not. This answer is a straightforward one.

Nobody doubts that Natural has to pay the $.43 to HIOS, and Natural, as one of the partners forming the HIOS combine, can be expected to ensure that Natural does pay it. Doutless it is an expense prudently incurred, as that term is used in rate cases. The trouble is the item was not incurred for the purposes of the gas business or for its avail. Instead, it is comparable to the transportation fee itself, meaning, in short, if the producers engage Natural to bring their oil ashore for their use and benefit (but entrained with Natural's gas), it is for the producers to reimburse Natural's expense of separating out the oil product, even as they reimburse Natural's expense for the transportation itself. That Natural has to pay it under the filed rate doctrine has nothing to do with the issue of how Natural is to get its money back. The argument fails; it proves too much and so, nothing.

Next, Natural provides testimony that the gas customers do indeed benefit, at least incidentally. Their witness assures us that, even if, *horrible dictu*, the oil were dumped at sea, and there were no reinjection into the gas stream as it heads for shore, there would still be needed some sort of a separation function, because of the tendency of the shoreward line to collect moisture at the low points in such quantity as to require its removal on shore before the gas would be ready for compression and interstate shipment (Ex. NGP-9, p. 2). Evidently these drops of water do come out, as a by-product of the re-separation function on shore, and to that extent it is indicated that the gas function benefits from the re-separation.

The trouble with this argument is that is begins and ends right there. There is nothing to indicate the amount or extent of this vicarious benefit and specifically nothing to suggest what it might cost, if anything significant at all, if there were not required the major function of separation of the oil. It is familiar that an expense that is not quantified is not cogniza-

ble. With such limited endorsement, and with no evidence whatever of its cost or value, it can hardly avail Natural here.[2]

All of this is not lost upon Natural, who is well aware of the clear dichotomy between the functions of the producer and of the pipeline in bringing the gas to market. Instead, they plead *ex past facto,* claiming the Commission orders the staff relies upon are of only a very recent vintage, and still not final. But their producer arrangements were made five to ten years ago and were quite in consonance with the then understandings; they bespeak exoneration because of what is termed the Commission's sudden change of position early in 1978, after their present producer contracts were entered into. There is indeed quite a saga on the subject.

Ever since 1954, the Commission has undertaken to assure that the costs of transporting liquids be not passed along to the gas consumers. Before 1968, the practice was to take up the problem on an individual basis when the producer applied for the certificate to sell gas. If the arrangement included some transportation of liquids, that cost would be allocated out. A 1968 notice proposed a policy to formalize that procedure; but the order[3] adopted four years later instead adopted a minimum rate for the transportation at

---

2. Recall that the rules argument was made, but did not prevail, in the proceeding leading to the adoption of the Commission's rule for a minimum transportation charge of $.20 per barrel for the liquids, Order No. 449 in 1972 (47 FPC 208. 215).

3. This Order (No. 449 of January 31, 1972, 18 CFR 2.71), (47 FPC 208) did not survive judicial review; a year later, it was vacated and remended in *Mobil Oil Corporation* v. *F.P.C.* 483 F. 2d 1238 (D.C. Cir. 1973). This was on jurisdictional and procedural grounds, not on the merits *per se.*

$.20 per barrel for liquid hydrocarbons. It was made applicable to all sales certified after March 1, 1972.[4]

From this, Natural understood the Commission had sanctioned their use of the gas pipeline to carry the liquids to shore, provided the minimum $.20 was collected on each barrelhead, presumable for credit to the pipeline's cost of service. From this, Natural infers that the function of separation of the liquids on shore is an incident of the transportation up to that point and so covered by the overall $.20 charge.[5]

Indeed, Natural points to one certificate proceeding approving a gas purchase from Texaco which included the transportation of Texaco's liquids for the $.20 charge, with Natural to install the separation facilities on shore at no cost to Texaco. The cost of the liquid separation facilities was recited in its exhibits (CP72-233, May 23, 1973, 49 FPC 1134). Since no question was raised about it, Natural reads this as an approval *sub silentio*.

Natural asks, if this dichotomy is to be enforced up to the hilt, so to speak, why must it be applied to Natural retroactively? That is, when producer arrangements long since have been made, filed and approved, which would leave Natural to

---

4. It is not only actual liquids, but that portion of the gas referred to as liquefiable, that also goes back to the producer. For that portion of the transportation, the order fixed a minimum rate of two cents per hundred miles per Mcf. The liquids and the liquefiable gases are here treated together. Note that the same rates, two cents per Mcf per hundred miles and 20 cents per barrel, had also appeared in the *Southern Louisiana Area Raza case*, Opinion No. 598, 46 FPC 86, which issued on July 16, 1971.

5. Thus, in 1962, on the remand of *Casco* from the Supreme Court, a cost of service was computed for the producer (but not specifically applied), which included a credit for the liquids transportation service by Tennessee on behalf of Continental, the Commission remarking. "A different problem arises with respect to the condensates which are transported to CATCO's Grand Chenier separation station, where they are removed and the gas redelivered to Tennessee. Such transportation in effect is a service performed by Tennessee for Continental and the other CATCO companies, and in a cost calculation a credit should be given Tennessee for an allocated part of the transportation costs." (27 FPC 96, 108.)

take the loss, without the opportunity to recover over from the contracted producers. Their point is that the orders relied upon are all very recent and indeed none yet is final. Less than two years ago Commission orders in the cases of *Union Oil* and *Canadian Superior Oil*[6] specifically address the problem of the on-shore separation facilities, installed for the purpose of segregating the producers' oil and for their benefit, and find "there is no justification to require the costs of such facilities to be borne by the pipeline's natural gas customers." Both are now pending on reconsideration.

It is with that background that the Commission approved the rates charged by HIOS for the service here in question, that is, in its rate order of December 22, 1978, in the case of the *High Island Offshore System*, CP75-104. The order directs HIOS to provide in its tariff that the recovery of costs associated with the handling of liquids and liquefiables must be through a separate charge, this because of the "outstanding issue as to whether the shippers may pass on such charges to their gas customers." The tariff filed by HIOS in compliance with their order makes the separation called for, since it provides a demand rate per Mcf of contract demand per month:

(a) for gas transporation—$4.55

(b) for liquid separation—$0.43

The outstanding issue referred to is the point of this case — recovery of that $.43 by Natural by its inclusion in its cost of service levied upon the gas customers.

Thus Natural's final point is a lot more apropos. Namely, even conceding that during the last year the Commission has specifically addressed the fine point about who bears the reseparation charge, and pretty clearly indicated it is not to be a burden on the gas customer, still Natural's contracts preceded those announcements by two years or more, and it is inequitable to saddle Natural or any other pipeline retroac-

6. CI77-828, April 12, 1978; CI77-802, March 28, 1978.

tively when it is entirely too late for the pipeline to incorporate a reimbursement provision in the producer contracts. One notes that a similar observation prevailed in the promulgation of the Commission Order No. 499 cited above, where the $.20 per barrel transportation charge was applied prospectively only.

The troubles with this argument are serveral, namely:

(i) As long ago as 1959, the Supreme Court announced to the profession that there was nothing to show that the producers were entitled to "free movement of distillates retained by the producers" (*Atlantic Refining Company* v. *P.S.C. of New York*, 360 U.S. 378, 393, (1959)); and it should have been as obvious then as it is now that the separation charge at the end of the transportation is merely a function of the transportation itself, that both charges are equally ineligible as a gas expense.

(ii) Amazingly, Natural has known this all along, because, as Natural concedes, at least three of the four producer contracts contain provisions requiring them to reimburse Natural for the cost here questioned. Why not the fourth one is not explained, nor whether it could not be amended at this time on the basis that its omission was a mutual error. Natural concedes, as to the three, in the narrow sense that Natural offers to credit to the cost of service any collection it might receive from them.

So the answer is that, instead of assessing this burden upon the hapless consumers, Natural should now and should long since have sent its bill for the amount to the several producers and taken whatever steps necessary to reform the one contract which, inexplicably, omits to mention it. Here, the item must be disallowed.

IV
Alternate Supply Programs—the Kalingas Project

The remaining issue in the cause is Natural's claim to recover outlays totaling $12,922,000 paid out during the 1970's (up to 1977) on three unsuccessful, unconventional and abandoned gas supply projects. Notably, there is no request for rate base treatment, *i.e.*, no program to incorporate the amount as capitalized rate base, nor to seek a return or depreciation on it. Instead, Natural includes in its annual cost of service the sum of $2,584,000, so as to amortize the bare project costs over a period of five years, without any interest or claim for earnings on the unrecovered balances.

All three were planned, or were the preliminaries to plans, to enhance the fuel supply available for Natural's many gas-hungry customers. The need can hardly be questioned.

With all that has been written, it is hardly news that there has been a severe gas shortage throughout the 1970's, and Natural has had its share, throughout the decade curtailing its customers much of the time. Most significantly, Natural serves a great and important part of the midwest region of the country, and its responsibility is to provide one trillion cubic feet of gas each year for their use and benefit. In sharp contrast, during the few years before these projects were started, Natural's additions to its conventional gas supply were only one-third of that annual burden, or perhaps 350 billion cubic feet per year.

Natural faced the stark truth that the era of plentiful gas had become past history, its reserve life index had dropped to a disturbing nine years. Their utility responsibility to continue service indefinitely commanded every effort, by conventional means or otherwise, to restore the index to a more respectable gas balance. It became evident that the required program would call for the outlay of a great deal of capital, with a long lead time between conception and fruition, and

that the resort to new types of supply programs entailed a lot of risk and manifest uncertainty. Bold action was called for. (Natural was hardly along — an initial decision of October 22 reviews 24 various such projects for the Tennessee Gas Pipeline Company, RP77-62.)

Kalingas, the first of Natural's three projects (and amounting to a third of the total), was the name given to a plan to bring out liquefied natural gas from Iran, starting in 1982. A consortium of companies assembled under that name had discovered substantial reserves off the coast of Iran,[7] had received a commitment from the Iranian Gas Company to export 1.6 Bcf a day as liquefied natural gas, and had undertaken to construct and operate the facility for its liquefaction. With a contribution of $4.7 million, Natural bought into the project and acquired the right or option to receive a five percent ownership share if and when they should contribute another $3 million, all by a date certain. Had the remaining $3 million been paid in, Natural would have acquired the five percent ownership "as well as the future right to the call of 400 million cubic feet of LNG."(4T136)

One gathers that Natural went into the ownership phase of Kalingas only reluctantly, it is out of their usual line to be a producer. But it was the only way to acquire the option on the gas itself, and at the time it gave every promise of an economical purchase. But within two years prospects became much less rosy. Costs began to escalate, and it came to pass the Natural was called on to triple its investment; like the second or third round in a poker game, the stakes were getting very high indeed. At the same time, some other potential LNG sources with less economic risk came in sight, and Natural finally made the policy decision to drop out of Kalingas. the prospects were still risky, and the hoped-for gas became too expensive, Natural folded; they dropped out of the deal.

---

7. We are told the reserve potential of the field to be tapped offshore Iran amounted to almost as much as the total 196 Tcf of proven United States reserves as of 1975.

Thus resulted the loss of their down payment (the $4.7 million) and the abandonment of the project. Natural now pleads for contribution to make itself whole (but without claiming any return or accrued interest).

The recent initial decision in the case of *Tennessee* turns down a group of similar projects on the basis they are presented as "R&D"—research and development—but do not qualify as such under then Order No. 483, 49 FPC 1054, 18 CFR 154.38(d).

For Kalingas, that approach is quite out of the question. Kalingas was not a research project of any kind and did not pretend to be. Natural presents it straightforwardly as an expense of operation, a prudent expense incurred in a good faith effort to meet the gas supply emergency, which should be allowed the same as any other expense, but only amortized over five years because it is a nonrecurring program.

Except for the small item of administrative expenses incurrred in the project, the Kallingas investment cannot be allowed, not because it is or is not research and development, not because it was or was not prudent, and not because it was or was not used and useful in the utility business.

The objection to the $4.5 million is on a much more fundamental matter. Substantially, it is an advance payment for gas; its purpose, as testified, was to acquire the option to buy, liquefy and import tremendous LNG reserves. It fails here because its objective equates it to the advance payment program. Even when advance payments were common for domestic producers, the Commission steadfastly denied any advance payments for foreign supplies — this because the prospect of their actual delivery was entirely too remote and speculative, see Opinion No. 769 of July 9, 1976, 56 FPC 120 in the case of *Tennessee* at 125.

It is not enough for Natural to respond that the advance payment cases contemplated additions to rate base and the accrual of a return thereon, while Natural here seeks only one-time reimbursement by the five-year amortization. The

Commission's policy objection is that the prospect of betterment to the rate payers was and is entirely too remote for the consumers to be called upon to underwrite investments in gas abroad. The item is disallowed.

One small part of the item remains and need not be disallowed. This was the concurrent expenses of $244,824, which are allowable and may be included as routine administrative expenses, the same as any other part of the cost of administration. That the program did not finally pass out is not relevant, any more than it would be for expenses of a lawsuit that was lost, or of a lawyer's brief that had to be rewritten. Subject to verification, this small portion of the item may be allowed.[9]

V

The Arctic Gas Project

Natural wants to write-off as an expense, and amortize in the rates over five years, a total of $7.922 million spent on the Arctic Gas study project. Of this sum, staff perceives that $1.219 has already been recovered from the rate payers, per Ex. ST-1 at page 3.

The background is this. Throughout the 1970's, until the last year or two, Natural was a member of Gas Arctic, a group of gas and oil companies seeking a plan to bring the Arctic Alaska gas to market. (Also, some nearby Canadian gas was under contract with Imperial and Exxon, two of the early produces in the Prudhoe Bay area.) It is recalled that the first decisional confrontation with the Arctic gas was the advance payment case, *sub nom. Michigan Wisconsin Pipe Line Company*, initial decision of January 22, 1973, 51 FPC at 394, where the statement of facts reveals that after completion of the original engineering study in 1970, "Michigan-Wisconsin,

---

9. Staff Brief refers to it as $244,824, but its testimony at St-1, page 5 lists it as $241,433. The correct and applicable amount for amortization may be verified and audited informally, between the staff and the company.

Natural and TransCanada joined with the three major producers in the Prudhoe Bay Field . . . to undertake a definitive study of all aspects of financing, constructing and operating a gas pipeline to the lower 48 United States." Those companies formed the Northwest Project Study Group, which "has been involved in extensive engineering, environmental, legal and economic studies related to the Arctic gas pipeline project."

A little later, a separate group, including four other large gas pipelines, formed the Gas Arctic System Study Group; and in June 1972, the two groups merged to form the Gas Arctic Northwest Project Study Group. Others were expected to join the organization, whose principal areas of study included engineering design and costs, environmental and sociological aspects, financial and economics, gas reserves, and legal and governmental requirements.

Later on, the certificate for a different proposed line (by then a distinct variation from the one originally conceived to run up the Mackenzie River Delta and across the Northwest Territory to Alberta) became the subject of a certificate case here in CP75-86, and this became part of the Commission's consolidated *Arctic Gas Pipeline* case, which ended up, after an intervening special Act of Congress, in a certificate for a similar, but somewhat different route, with much more of it through the state of Alaska (February 1, 1977 in CP75-96, 58 FPC 1127).

Natural incurred major costs in the preparation of the studies required to support the application for their route, especially those covering the environmental aspects. From the initial decision on the Alaska line as first approved, it is obvious the research and background and engineering and other studies by the several original applicants were taken advantage of, indeed formed the basis for the decision that the line could and should be built. Thus, among many examples, at 1261, *supra*, it is mentioned that the numerous design deficiencies of the final applicants "can be resolved by Arctic Gas' solutions" for comparable problems.

Natural is not now part of the Arctic consortium, but it hopes and rather expects to share in the gas when it finally reaches the middle west.[10] With its own project dead, at least as far as can be foreseen, Natural wants reimbursement for its engineering, technical, scientific and professional expenditures in the neighborhood of $7 million which it laid out in order to prove the efficacy of *their* (and perhaps *any*) Arctric project.

As in the other cases herein, only the staff opposes and, indeed, it is quite notable that a great number of Natural's distributor customers intervened in the cause but none has filed a brief opposing this request for an increase in Natural's rates based, to the extent stated, upon the outlays discussed herein.

Much of the argument goes back and forth rather futilely on the question whether this program qualified as research and development, recapitulating the considerations weighed in the recent initial decision in the case of *Tennessee*, as cited above, which turned down the costs of 125 different environmental, engineering and similar studies on the proposed Alaska line, it appearing that, not developing a new technology, they do not qualify as R&D, so Tennessee should defer its claim and capitalize the costs incurred when and if the gas shall ever flow to it.

Depending wholly on how you look at it, an argument on "R&D" could go either way — the dozens of unique and unprecedented problems of pipe line construction is the Arctic, all as expatiated upon through many hearings here over the past ten years, obviously required a lot of research and development for their solution; they are not at all like the methodologies long since developed for pipeline construction in the lower 48 states. On the other hand, if this work is looked upon as merely the preliminary part of the nation's

---

10. In the current certificate phase of the Arctic program (CP)1-123), one notes that ten different pipelines, including Natural, have such an interest that they have intervened in the on-going proceeding.

broad program of devloping and building a pipe line from the Arctic shores of Alaska to the Midwest — at $5 or $10 billion, the largest construction program in history — it is a huge and expensive program in actual operation, far beyond the status of pure research or of R&D or even of RD&D.

It is the suggestion the R&D dichotomy is quite inappropos as a guide; the question should be approached on its merits, not as an exercise in etymological semanticisms on what is the dictionary meaning of research or what can be covered in the regulation.[11] Rather, the issue should be whether the expenses were prudently incurred, whether they were, directly or indirectly, for the benefit of the gas consumer, whether that benefit gives some promise of finally being achieved, and, most significantly, how the expenses underlying that burden should be shared among all who benefit.

Here the point is this — considering all the applications filed and the three or four routes seriously considered and the one finally settled upon, the Alaska project is the culmination of the engineering and legal research contributed by a very great number of pipelines (and others); all should be treated alike and its totality should be measured and the incidence of its burden broadly as well as fairly. With the line not yet built or even financed, it cannot be sure where the line will go or who will be in a position to benefit from it, although its significance may be so great that all American consumers will benefit by displacement, if not otherwise.

It is suggested the problem is not one for determination in connection with a single pipeline, with quite varying results depending on the hazards of litigation. Instead, it is the rec-

---

11. After all, the regulation shows "R&D" is a part of the Commission's Uniform System of Accounts. 18 CFR Part 201, par. 188 and definition 28B. It is a directon to the utilities' bookkeepers to charge routine R&D to Account 188, and to amortize to operating expenses over five years the larger and non-recurring items. But, while they have bearing, "an accounting rule does not govern rate making . . . "*Tennessee Gas Pipeline Co.* v. *F.P.C.* 561 F.2d 955, 957 (D.C. Cir. 1977).

ommendation that, at an appropriate time, a rulemaking proceeding be announced, inviting all the dozen or two pipelines that participated in any way in the Alaska project to assemble their expenses incurred, demonstrate their relevance and measure of benefit, and claim reimbursement accordingly, to be allocated as widely and fairly as possible among all those who stand to reap the benefits of the project which finally evolved.

Thus one notes that much of the staff's opposition to the $7 million Arctic gas item is based on its correlation with the others in the several Arctic groups, the staff feeling that the allowance here would somehow make Natural's customers pay an undue share of the total, if and when Natural participates in the final gas flow. Meanwhile, quite a number of other dockets are cited by both parties where the same question has been or is being considered. Manifestly, a single Arctic gas program is plainly indicated, with the aim to reach a consistent result.

In addition, the treatment suggested would allay one further objection of the staff to the effect that Natural is undertaking to collect its expenses now, whereas the successful applicants and present participants in the project get nothing until the gas finally flows. The treatment suggested would contemplate that all of the many lines that have participated at one time or another assemble their pre-construction expenditures and amortize them in their current rates, so that all rate payers will share in the reimbursement burden concurrently. Somehow, staff conjures the further point that allowance here would deter Natural from seeking participation in the eventual gas flow; however, Natural assures us that is certainly not the case.

There is nothing to the staff's final point as to why the pipeline applicants should get their expenses paid when the intervenor environmentalists do not, a difference thought to be opprobrious. But that ignores that the burden to make those expensive studies is one imposed upon the applicant by regulation. Anyway, the difference claimed, if it be one, has

governed every case that has ever been before this Commission or its predecessor. Whether intervenors in opposition should have some allowance, whether from the public treasury, the company treasury, or the rate payers, is a political question and not one to be determined or considered here.

Accordingly, the item is here disallowed, but without prejudice to its further consideration by the procedure suggested.

VI

The Coal Gas Project

Seven or eight years ago, when the gas shortage began to be viewed seriously, Natural undertook the beginnings of a coal gas project, with a facility to be located in Dunn County, North Dakota, and with the objective to produce 250 MMcf of gas per day. The leases and options were acquired in 1973. Consultants were engaged to prepare the basic studies for the gasification process, including an environmental report. While Natural spent around $11 million for the coal leases and the like, it here seeks to include much less, or $1.474 million, representing that portion of the 15 studies undertaken which are no longer applicable to the project.

The point is, the project has fallen on evil days and is now shelved, virtually if not formally abandoned. In 1976 the state water commission voted a denial for the essential state water permit. Next, after the environmental report was completed, two new Federal acts were enacted and many regulations, making much of the prior studies no longer relevant or of avail. The plant itself may require to be redesigned, anyway it cannot be financed as planned. Natural wants to write-off the unusuable parts of their investment and amortize the cost, to the amount stated.

Natural laid out something over $3 million for environmental and process-related study costs, but now seeks to amortize somewhat less than half of that amount, $1.474 mil-

lion, representing those studies which are no longer valid or utilizable because of the changing ground rules, new environmental laws and the like. Meanwhile, Natural has become involved in a new and different coal gasification project to be located in Mercer County, North Dakota, where some of the expenditures within the $3 million total have been transferred and will be appropriately recognized.

Not regarding it as significant that Natural wants only to amortize its bare outlay — they do not seek to capitalize the expenditures as part of the rate base with an allowance for return and depreciation for years to come — the staff's basis for opposition finds expression in the traditional "used and useful" test by which rate base items must normally be found to qualify. Of course, if that is the test, the case is at an end, for Natural's very claim in that these expenditures were for a group of studies that, due to changing conditions, cannot be used at all.

Natural's response is to rely upon the more customary test for expenditures, as distinguished from capital investments, meaning a proof that the expenses were prudently incurred. Indeed, no one here questions the prudence; and there is no reason, in all the circumstances, to doubt that Natural was justified in proceeding to incur them. The natural gas reserve as we have known it for a century, was seen to be running out; and it was Natural's business, indeed duty, to seek out every feasible means of continuing to supply the public need.

That it was prudent for Natural to enter into a proposal for a coal gas program can hardly be doubted; manifestly, in the circumstance of the shortage perceived, it would have been imprudent not to, as many pipe lines have long since demonstrated. Too, its promise of eventual rate recognition in the customers' accounts may have been buoyed up by the Commission's then-current pronouncement promoting the advance payments program, meaning the program for charging to the customers the cost of gas not yet discovered or at least developed. This found its expression in Order No. 410 of

October 2, 1970, 44 FPC 1142, 1144, where the policy pronouncement was made that:

> It is the Commission's view that, particularly at the present time when there are indications of a natural gas shortage, it is not in the public interest for pipeline companies to bear the cost of assuring themselves and their customers of a future supply of natural gas.

However, this broad field of promise with respect to advance payments did not achieve transliteration into programs for unconventional gas projects, such as coal gasification. Though the advance payments may cover the dry holes as well as those that are productive, the consumers have not yet been called upon to pay the costs of development of any of the several unsuccessful coal gas projects. Thus —

(i) Delay rental payments for a proposed coal gasification program were disallowed in the case of Michigan-Wisconsin (1974), 51 FPC 2408.

(ii) Northern Natural may not count as research and development a series of studies preliminary to a decision on whether to construct a coal gas plant proposing to use the Lurgi process. Opinion No. 14 of May 10, 1978, 3 FERC ¶ 61,131.

(iii) Natural may not include its coal lease option payments in its cost of service in a rate case. Opinion No. 782 of November 9, 1976, 56 FPC 2976.

(iv) Similarly, in orders of September 4 and October 30, 1974, in Southern Natural, RP74-93, it is announced that the Commission is not "at this time inclined, as a matter of policy, to permit the *ad hoc* inclusion in pipeline costs of service of expenses which would otherwise be capitalized to a planned coal gasification project."

Natural is not blind to the staff's panoply of authority so marshaled, but instead insists that the only true test is whether the program was a prudent one, whether the expend-

itures were prudently incurred at the time they were made for the eventual benefit of the gas-consuming public they serve. Natural finds their program quite comparable to many others where projects undertaken prudently and in good faith are permitted cost recovery, such as a number of unsuccessful gas storage projects where rate treatment has been permitted (citing *Souther Natural*, 29 FPC 323, *Midwestern*, 32 FPC 993 and *Northern Natural*, 45 FPC 1050).

Next, Natural compares the routine item for dry hole expenditures in computation of producer costs, which was allowed without question in the original producer rate case of *Phillips*, 24 FPC 537, has been applied to pipe lines, and is included in the area rate structures. If unsuccessful drilling can be charged to the customer, why not unsuccessful coal gas projects? Similarly, El Paso received its exploration and development expenses as part of its cost of service, in 22 FPC 659. Next, the now-abandoned advance payment program had a device for recovery of costs where the advances are not repaid by the producer, see Account No. 166.

Finally, Natural finds peculiarly approsite the Commission's liberality in the electric rate cases where, as the Commission remarked only a few weeks ago (*Southern California Edison Company*, Opinion No. 62 of August 22, 1979, 8 FERC ¶ 61,198); "Abandoned projects have become an increasingly familiar expense in the electric utility industry for a variety of reasons." Amortization was permitted. So, a month previously, New England Power Company was permitted to amortize $13.5 million in a canceled project for a new generation unit (Opinion No. 49 of July 19, 1979, 8 FERC ¶ 61,054).

It is evident that the rationale for the denial in the coal cases is not found in the fell result that they all represent abandoned projects. For, as the Commission philosphized in the New England Power case of last July —

> It is evident that unless security holders are shielded against risk of losses resulting from aborted projects by way of inclusion in cost of service, the

> cost of capital will be higher to an extent necessary to compensate for the additional risk. Thus, if rate of return is required to be sufficiently high to enable the public utility to attract capital, the risk of such losses must be borne by ratepayers either directly (through cost of service) or indirectly (through rate of return).

Rather, the coal gasification process is seen as a new and unconventional source of gas, yet to be proved and found adaptable to the gas industry. The result is the policy pronouncement of only a year ago in the rehearing in the case of *Northern Natural*, Opinion No. 14-A of September 14, 1978, 4 FERC ¶ 61,312, which concludes —

> We have recently reaffirmed our established policy of disallowing the costs of unsuccessful alternate gas supply projects to be included in jurisdictional rates (citing Opinion Nos. 801 and 728). In those cases we have held that, while we endorse such efforts as potentially beneficial to the interstate market, we view the risks associated with such efforts as properly borne by the shareholders and not the jurisdictional ratepayer.

In the face of those policy pronouncements, the staff finds it inexorable that the claimed costs of the Dunn County Project now virtually abandoned must be disallowed, and, at least as the record stood at the time of the hearing and briefing, this forum would have no option or leeway to hold otherwise.

So the dichotomy stands unresolved — unsuccessful supply or capacity projects may be allowed in the rates for gas producers (the dry holes), for gas pipe lines (storage projects, R&D expenses, LNG,[12] etc.), and for electric companies ("an

---

12. As to LNG: "In Opinion No. 622-A, *Columbia LNG Corporation, et al.* we incorporated a provision which enabled the seller to bill the buyer for all out-of-pocket expenses in the event the seller was unable to deliver any gas for a period exceeding one day." (From 53 FPC 1287, 1305).

increasingly familiar expense"), but not for coal gasification projects. For them, venturesome companies exploring this untested field are remitted, for their losses, to the risk element contained in the rate of return. Indeed, staff reads Natural's last rate case here as so providing, where Opinion No. 762, 55 FPC 2328, of May 21, 1976 speaks of —

> . . . the necessity for pipelines to enter into expensive financing of new gas supplies by way of advance payments and direct equity investments . . . (at 2334) and
>
> . . . the risks associated with the outlay of the vast sums of capital needed to develop remaining new supplies . . .

The Company finds nothing in that language to saddle its treasury with the risks of new and unproductive projects; while the reaction here is that, out of two dozen cases over twenty years, one does not recall a single staff witness adding any "points" to his recommended return based on the technological risks of investment in aborted supply projects. Any only last July, Opinion No. 49 speaks of the need to shield security holders from the risk of loss in aborted projects, lest the cost of capital be too high, see above.

In contrast, in the very first coal gasification case, the Commission, confronted with a demand for a full cost of service tariff, with guaranteed return, gas or no gas, responded with a formula designed to assure recovery of the investment and a means by which the applicant will recoup "all reasonable and prudent costs that are incurred." (*Transwestern*, Opinion No. 728 (1975), 53 FFC 1287, 1300). If the production should be impaired for any reason, only the rate of return was affected, not the recovery of costs laid out.

However negative were the Commission's precedents and policy statements as of September, when the briefs were filed, the situation has now changed full circle. On the 21st, ultimo, in the case of the *Great Plains Gasification Associates*, Opinion No. 69, 9 FERC ¶ 61,221, has authorized a coal

gasification program, as a demonstration project, including a full cost of service tariff, a current surcharge to the gas customers of the construction costs as incurred, and a full recovery, in the event the project fails or abandonment is required, of all costs prudently incurred, including expenditures, debt cost and equity return. If the test of prudence is met, " . . . we do not think it inappropriate under these circumstances for the sunk investment to be recovered from the ratepayers." (page 65)

Natural is one of the five pipe line partners in Great Plains. In effect, the Dunn County project whose mortal remains are the subject of today's case has been moved to Mercer County, Natural has brought in four substantial partners, and its scale has been cut in half, to 125 MMcf of coal gas per day. The pipe lines are warned (p. 111) that *Great Plains* is not to be a precedent; that other projects would have to qualify similarly against the public interest standard, at least to be accorded the financing treatment like "R&D."

For the Dunn County project, a predecessor of Great Plains, Natural seeks only out-of-pocket cost reimbursement, not the cost plus return now allowed. One cannot read together *Great Plains'* No. 69 *Transwestern's* Opinion No. 728, and the other cases cited except upon the synthesis that gas supply projects, unconventional or not, when begun in good faith and in strict prudence as efforts to relieve the nation's gas shortage, may be recognized in the pipe line's rates to the limited extent of amortizing their bare, out-of-pocket costs in the event of particular failure. The public utility duty of the pipe lines to inaugurate programs for gas supply superinduces the public interest obligation of reimbursement upon the consumers to be benefitted. It is simply an expression of the premise that the consumer who uses up the supply is to be called upon to share the burden of replacing it.

The coal gas item may be allowed.

VII

Order

Accordingly, *It is ordered.* Subject to Review by the Commission, that—

(A) Within 30 days from the effective date of this decision, Natural Gas Pipeline Company of America shall make appropriate revisions to its accounts and rate filings in accordance with the findings and conclusions of this decision and in light of the settlement agreements filed in this docket.

(B) Within 30 days from the effective date of this decision, Natural Gas Pipeline Company of America shall make refund to its customers of any amounts collected in excess of those rates which in conformity with the findings and conclusions herein would be just and reasonable, with interest from the date of payment to the date of refunds, at the interest rate prescribed by Commission Rules and Regulations.

(C) Post-hearing exhibits ST-4 to 9, NGP-11 and item by reference F are admitted to the record, no further examination on them appearing to be required.

(D) *Staff's* motion to reopen the record with respect to HIOS is denied as unnecessary in the light of the action taken on that item above.

WILLIAM L. ELLIS,
Presiding Administrative Law Judge.

Supreme Court, U.S.
FILED
DEC 9 1985
JOSEPH F. SPANIOL, JR.
CLERK

NO. 85-592

IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

NATURAL GAS PIPELINE COMPANY OF AMERICA,

Petitioner,

v.

FEDERAL ENERGY REGULATORY COMMISSION,

Respondent.

BRIEF OF AMERICAN GAS ASSOCIATION AS *AMICUS CURIAE* IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

GEORGE H. LAWRENCE
DAVID J. MUCHOW
*CAROL A. SMOOTS
American Gas Association
1515 Wilson Boulevard
Arlington, Virginia 22209
(703) 841-8498

Attorneys for
American Gas Association

*Counsel of Record

December 9, 1985

BEST AVAILABLE COPY

TABLE OF CONTENTS

Page

INTEREST OF *AMICUS CURIAE* 1

SUMMARY OF ARGUMENT 3

1. BY REFUSING TO ALLOW THE RECOVERY OF PRUDENTLY INCURRED EXPENSES, THE COURT OF APPEALS DECISION, AFFIRMING THE FEDERAL ENERGY REGULATORY COMMISSION ORDER, JEOPARDIZES THE FINANCIAL INTEGRITY OF GAS COMPANIES AND VIOLATES THEIR RIGHT TO RECOVER THEIR REASONABLE COSTS 4

2. THE CHALLENGED DECISION ERRS IN ESTABLISHING INCONSISTENT RATE TREATMENT FOR ABANDONED PROJECT COSTS AND REPRESENTS A HOSTILITY TO THE DEVELOPMENT OF NONTRADITIONAL GAS SUPPLIES 8

CONCLUSION 12

TABLE OF AUTHORITIES

Page

Cases

American Public Gas Association v. *F.P.C.*, 546 F.2d 983 (D.C. Cir. 1976) 8

Arkansas Louisiana Gas Co. v. *Hall*, 453 U.S. 571 (1981) 9

F.P.C. v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944) 5

F.P.C. v. *Memphis Light, Gas & Water Division*, 411 U.S. 458 (1973) 5

F.P.C. v. *Sierra Pacific Power Company*, 350 U.S. 348 (1956) 9

F.P.C. v. *Texaco, Inc.*, 417 U.S. 380 (1974) 3

Michigan Wisconsin Pipe Line Co. v. *F.P.C.*, 520 F.2d 84 (D.C. Cir. 1975) 8

NEPCO Municipal Rate Committee v. *F.P.C.*, 668 F.2d 1327 (D.C. Cir. 1981) 7,8

Permian Basin Area Rate Case, 390 U.S. 747 (1968) 5

Tennessee Gas Pipeline v. *FERC*, 606 F.2d 1094 (D.C. Cir. 1979) 8

Wisconsin v. *F.P.C.*, 303 F.2d 380 (D.C. Cir. 1961) 8

Administrative Decisions

Midwestern Gas Transmission Co., 32 F.P.C. 993 (1964) .. 8

New England Power Co., 8 FERC ¶ 61,054 (1981) 6,7,8

Panhandle Eastern Pipe Line Co., 25 F.P.C. 787 (1961) ... 8

Phillips Petroleum Company, 24 F.P.C. 537 (1960) 6,8

Southern Natural Gas Co., 29 F.P.C. 323 (1963) 8

Page

Statutes

Natural Gas Act, 15 U.S.C. § § 717, *et seq.* (1982)
Section 4, 15 U.S.C. § 717c 9
Section 5, 15 U.S.C. § 717d 9

Federal Power Act, 16 U.S.C. § § 791a-825u (1985)
Section 205, 16 U.S.C. § 824d 9
Section 206, 16 U.S.C. § 824e 9

Miscellaneous

American Gas Association, *Gas Facts: A Statistical Record of the Gas Utility Industry* (1974) 2

American Gas Association, *Status of SNG From-Liquid Hydrocarbon Plants*, Gas Energy Review, Aug. 1985 10

American Gas Association, *Fact Book: Synthetic Pipeline Gas From Coal* (1979) 11

Sarkes, Iribe and Smith, *LNG: Current Status Confirms Its Technical Maturity, Pipeline and Gas Journal*, Nov. 1978 11

NO. 85-592

IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

NATURAL GAS PIPELINE COMPANY OF AMERICA

Petitioner,

v.

FEDERAL ENERGY REGULATORY COMMISSION,

Respondent.

BRIEF OF AMERICAN GAS ASSOCIATION AS *AMICUS CURIAE* IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

INTEREST OF THE *AMICUS CURIAE*

The American Gas Association (A.G.A.) is a national association representing the interests of approximately 300 member companies involved in the distribution and transmission of natural gas throughout the 50 states. Our member companies account for approximately 85 percent of all domestic regulated gas industry sales. The Natural Gas Pipeline Company of America (Natural), petitioner in this case, is a member of the A.G.A.

This case involves review of a decision of the U.S. Court of Appeals for the District of Columbia Circuit, affirming orders of the Federal Energy Regulatory Commission (Commission or FERC), denying Natural the recovery from rates of certain abandoned project costs. Natural was denied recovery of its out-of-pocket investment costs for three nontraditional gas supply projects. They include costs associated with a coal gasification project,[1] a liquefied natural gas (LNG) project

[1] Also referred to as a synthetic natural gas or SNG project.

and an effort aimed at transporting gas from Alaska to the lower 48 states.

These projects arose in the 1970s, a period of acute supply shortage for Natural and for the natural gas industry. Natural entered into these supply projects because they presented an opportunity to obtain significant gas supplies for the future. The investments were made when the deliverability of Natural's traditional supplies was insufficient to meet the pipeline's requirements. The deliverability of traditional gas supplies was also expected to decline even further. It is not disputed that Natural needed the additional supplies to serve its gas customers.

The Court of Appeals affirmance of the Commission's ruling is of vital interest to A.G.A. and its membership. In denying the recovery from rates of prudently incurred costs for abandoned supply projects, precedent is established which injures the entire natural gas industry. In addition, the failure to indicate any reasoned basis for treating failed gas supply projects differently from other types of supply projects is especially troublesome. The decision presents questions of major importance warranting review by this Court.

The natural gas industry is damaged in four major ways by the challenged decision and orders:

First, by disallowing even prudent investment costs for abandoned supply projects, the decision has a chilling effect on all industry efforts to develop new gas supplies. At a time when natural gas accounts for over 24 percent[2] of our domestic energy needs and demand is increasing by approximately 4 percent[3] a year, the development of new gas supplies is of vital importance to the nation, gas consumers and the gas industry. The holding below substantially reduces the incentives for pipelines and others to attempt to develop new supplies.

Second, the decision undermines the gas industry's efforts to compete with the providers of alternate fuels. As discussed

[2] American Gas Association, *Gas Facts: A Statistical Record of the Gas Utility Industry* 127 (1984).

[3] *Id.* Reflects the approximate increase from 1983 to 1984.

herein, the FERC has permitted electric companies to recover their "dry-hole" costs in rates. The oil industry is unregulated and thus may also include the cost of unsuccessful supply projects in prices. By requiring gas companies to charge all such costs to shareholders, gas companies face greater financial risk, increased difficulty in attracting capital and a resulting disadvantage in competing with alternate fuels.

Third, the decision is inconsistent with one of the Commission's major responsibilities. Under the Natural Gas Act, the Commission must assure an adequate gas supply for consumers. See e.g., *F.P.C.* v. *Texaco Inc.*, 417 U.S. 380, 388 (1974). The decision provides a substantial disincentive for pipelines and others to develop adequate gas supplies for their markets. This is inconsistent with the Commission's obligations and, over time, threatens gas consumers.

Fourth the decision threatens the financial health of gas companies. Pipelines and distributors are charged with the responsibility to serve customer gas requirements but are denied cost recovery when they prudently incur expenses to develop gas supplies. It is fundamentally unsound for the FERC to impose service requirements on pipelines and then apply a financial penalty when they attempt to develop necessary gas supplies. This is particularly damaging when, as here, traditional suppliers were unable to fulfill the company's gas requirements.

In light of the importance of the issues presented, and the gravity of the harm to the industry from the Court of Appeals and FERC decision, A.G.A. files this *amicus curiae* brief in support of the petition for a writ of certiorari filed by Natural.

SUMMARY OF ARGUMENT

The Court of Appeals decision, affirming the Commission order, presents at least two major issues of importance to the gas industry and to the supply security of this nation.

First, by denying recovery of the prudently incurred out-of-pocket costs for abandoned gas supply projects needed to satisfy customer requirements, only the immediate financial

interests of consumers are advanced. This Court has long held that in establishing just and reasonable rates the Commission must balance the interests of consumers and gas companies. The Court of Appeals and Commission have departed, without cogent reasoning, from prior holdings which adopted the very balancing of interests advocated by Natural.

Second, the challenged decisions establish inconsistent rate treatment for abandoned projects. Although the Commission and appellate court have permitted cost recovery for failed electric generating projects, unsuccessful gas exploration and gas storage facilities, they have denied recovery for nontraditional gas supply projects. No factual or statutory differences justify this inconsistent treatment. This inconsistent rate treatment financially damages gas companies, adversely affects the development of nontraditional gas supply projects and undermines the industry's ability to fulfill gas service obligations.

ARGUMENT

1. BY REFUSING TO ALLOW THE RECOVERY OF PRUDENTLY INCURRED EXPENSES, THE COURT OF APPEALS DECISION, AFFIRMING THE FEDERAL ENERGY REGULATORY COMMISSION ORDER, JEOPARDIZES THE FINANCIAL INTEGRITY OF GAS COMPANIES AND VIOLATES THEIR RIGHT TO RECOVER THEIR REASONABLE COSTS.

For over forty years, this Court has explicitly held that the obligation of the Commission in establishing "just and reasonable" rates is to balance the interests of gas consumers and gas companies. This balancing requires that the Commission protect consumers against exploitation while promoting the financial integrity of natural gas companies. Thus, in reviewing a Commission order from the perspective of the gas company, "the court must determine whether the order may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the

risks they have assumed." *Permian Basin Area Rate Case*, 390 U.S. 747, 791-792 (1968); *F.P.C.* v. *Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944).

This standard was applied in *F.P.C.* v. *Memphis Light, Gas & Water Division*, 411 U.S. 458, 474 (1973), to overturn a Court of Appeals decision which looked only to the question of consumer benefit. The appellate court's holding, "that the consumer interests were not furthered", fell short of the application of the appropriate standard for review. By looking only to whether the consumer interest was furthered, the appellate court had failed to consider the financial health of the pipeline.

In this case, the prudently incurred gas supply project costs of a pipeline were excluded from rates because it was found that the failed projects were not "used or useful" to consumers. By looking only to the usefulness of the immediate project, and not to the prudency of investments necessary to assure adequate gas supply, the Court of Appeals only considered whether the immediate consumer interest was furthered. The decision reflected no consideration of the need for investment in gas supply projects. It also failed to consider the financial harm to pipelines and their shareholders from applying such a narrow test. As in *Memphis Light*, this falls short of the standard established by this Court.

The essence of the requirement that rate orders must be reasonably expected to maintain financial integrity, attract capital and compensate investors for risk is that gas companies are entitled to recover their costs when they act reasonably and make prudent investment decisions. If rate decisions are based only on whether the result of an investment was a useable project, and the pipeline is denied recovery for all "dry hole" expenses, there is no balancing of risks and benefits. There is no balance of interests if when a supply project is successful the consumer benefits by receiving power but when there is a "dry hole" they do not bear the cost and are thereby insulated from the financial consequences.

The consumer interest is protected by the requirement that companies can only recover their costs when their investment decisions are reasonable and prudent. The proposal by

Natural that it only recover the out-of-pocket costs for the terminated projects, gave weight to both consumer and pipeline interests. The proposal permitted recovery of costs but did not seek any return on the investment for the abandoned project.

Prior commission decisions have acknowledged the need for consumer rates to reflect the full cost of providing service. As the Commission stated in *Phillips Petroleum Company*, 24 F.P.C. 537, 559 (1960):

> The gas consumer must pay rates sufficient, amont other things, not only to amortize the cost of successful past drilling which makes present service possible, but also the current losses and other expenditures incurred in an attempt to replace the gas currently being produced and consumed and continue service in the future.

This reflects the mutual interests of gas consumers and gas companies in developing and replacing gas supplies. The policy considerations reflected in this opinion apply with equal force to a pipeline which develops its own supplies as it does with the traditional gas producer.

It is also financially unrealistic to expect investors to assume the risk of loss for the many supply projects which gas companies must invest in to provide reliable service to their customers. Investors are only compensated by a return on invested capital. A rate of return adequate to compensate investors for the risk of large, capital write-offs for unsuccessful supply projects, would need to be at unprecedented levels. The resulting higher rates would act to the long-term detriment of consumers and gas companies.

In a case directly analagous to the one at issue, the Commission interpreted the "used and useful" standard to distinguish its application from the situation presented here. *New England Power Co.*, 8 FERC ¶ 61,054 (1981). The "used and useful" standard was applied to deny the inclusion in rate base of plants which were cancelled. The standard did not bar recovery from rates of the actual costs incurred from the failed

projects. Thus, as in this case, where the company only seeks cost recovery, rather than a return on investment, the "used and useful" standard is inapplicable.

In *New England Power*, the Commission allowed a company to amortize over a five-year period its losses on a cancelled oil-fired electric generating unit. Although the administrative law judge had found the expenditures to be of a preliminary nature, the Commission permitted recovery because it found no evidence that the investment was imprudent or the costs unreasonable. The Commission explained that the "used and useful" standard justified excluding the costs from rate base. The Commission stated there was "no precedent" for "requiring ratepayers to pay a return on an expenditure that has not resulted in productive plant that is used or useful in the public service." 8 FERC ¶¶ 61,054, 61,175. It was not disputed, however, that because the investment was prudent when made, the company was entitled to recover the costs incurred. This result was found by the Commission to be an "equitable balance between the interests of investors and ratepayers." 8 FERC ¶¶ 61,054, 61,175.

In affirming the Commission's decision, the Court of Appeals also held this to be the appropriate balancing of interests between consumers and companies. As it explained:

> Because it would be inequitable to place on the utility the entire loss of expenditures prudent when made, FERC allowed recovery thereof over time. At the same time, FERC is charged with a duty to protect the consumer against unreasonably high rates. Far from an inconsistency, FERC here struck a reasonable balance between the interests of investors and ratepayers.

NEPCO Municipal Rate Committee v. *FERC*, 668 F.2d 1327 (D.C. Cir. 1981).

No reasoned analysis supports the Commission and appellate court's departure in this proceeding from the balancing of interests established in the *New England Power* decisions. They adequately reflected the established principles of this Court.

2. THE CHALLENGED DECISION ERRS IN ESTABLISHING INCONSISTENT RATE TREATMENT FOR ABANDONED PROJECT COSTS AND REPRESENTS A HOSTILITY TO THE DEVELOPMENT OF NONTRADITIONAL GAS SUPPLIES

The Court of Appeals decision, affirming the FERC order, establishes inconsistent and discriminatory rate treatment for abandoned gas supply project costs. The distinctions in treatment are based on the type of energy provided or whether the party involved is a pipeline or a traditional gas producer. In addition, contrary to the facts and without any support in the record, the court brands all LNG and SNG projects as "exotic", "unproven" and "radically different from orthodox methods". App. 35a. This is provided as support for the inconsistent treatment of costs from such projects. This action is inconsistent with FERC's obligation to act in a consistent and even-handed manner in deciding similar issues on different pipelines. *Michigan Wisconsin Pipe Line Co.* v. *FPC*, 520 F.2d 84, 89 (D.C. Cir. 1975); *American Public Gas Association* v. *FPC*, 546 F.2d 983, 988 (D.C. Cir. 1976).

The Commission has repeatedly allowed recovery of expenses incurred by companies in unsuccessful projects undertaken to supplement or improve service. The Commission has allowed recovery for unsuccessful gas storage projects. *Southern Natural Gas Co.*, 29 FPC 323 (1963); *Midwestern Gas Transmission Co.*, 32 FPC 993 (1964). In *Tennessee Gas Pipeline* v. *FERC*, 606 F.2d 1094 (D.C. Cir. 1979), the Court of Appeals discussed and approved of exceptions to the "used and useful" requirement for including storage project costs in rates. Similarly, the FERC has allowed recovery of unsuccessful gas exploration costs by producers and pipelines. *Phillips Petroleum Co.*, 24 FPC 537 (1960), affd. *Wisconsin* v. *FPC*, 303 F.2d 380 (D.C. Cir. 1961), affd. 373 U.S. 294 (1963); *Panhandle Eastern Pipe Line Co.*, 25 FPC 787 (1961). Finally, the Commission has permitted electric utilities to amortize prudently incurred expenses from unsuccessful generation projects through the cost of service. *New England Power Co.*, 8 FERC ¶ 61,054 (1979), affd. *NEPCO Municipal Rate Comm.* v. *FERC*, 668 F.2d 1327 (D.C. Cir. 1981), *cert. denied*, 457 U.S. 1117 (1982).

Although the "used and useful" concept has been utilized by FERC to deny recovery of abandoned supply project expenses, it has often been disregarded for traditional gas and electric projects. The FERC has only been consistent in denying cost recovery from LNG, SNG and other nontraditional gas supply projects.

No rationale exists for the inconsistent treatment accorded Natural's abandoned supply projects. As with the failed projects where cost recovery has been allowed, Natural entered into the projects to meet its customer's gas requirements. The projects were expected to provide significant quantities of gas, over the long term, to assure continued service to customers. The Court of Appeals offers three major reasons for treating Natural's project costs differently. None of these reasons withstand scrutiny.

First, the Court of Appeals offers that the statutory schemes governing electric and natural gas utilities vary somewhat and thus different treatment of electric and gas project costs is justified. This Court has held that comparable provisions of the Federal Power Act and the Natural Gas Act "are in all material respects substantially identical." *Arkansas Louisiana Gas Co.* v. *Hall*, 453 U.S. 571, 577 n.7 (1981); *F.P.C.* v. *Sierra Pacific Power Company*, 350 U.S. 348, 353 (1956). Sections 205 and 206 of the Federal Power Act, 16 U.S.C. § § 824d and 824e, are substantially the same as Section 4(e) and 5(a) of the Natural Gas Act, 15 U.S.C. § § 717c and 717d. There is no statutory distinction which would warrant different regulatory treatment.

Second, the appellate court cites the certificate requirement for gas companies as support for the inconsistent treatment of gas and electric supply projects. The FERC has no certificate authority over the production or gathering of natural gas. The fact that the Commission does have certificate authority over pipeline facilities, but not over electric activities, is simply irrelevant to the separate issue of cost recovery. The central issue to cost recovery is whether the costs were prudently incurred. In determining whether to permit recovery of failed project costs, the Commission is as free to accord electric

generation expenditures the same degree of scrutiny as in a gas certificate case. This "after the fact" inquiry should enhance, rather than diminish, the Commission's ability to review supply project costs.

Finally, the decision distinguishes recovery for failed gas storage projects by characterizing them as "the normal activity of a pipeline seeking to maintain its physical plant and equipment". App. 28a. We submit that storage has nothing to do with maintaining pipeline equipment. Both the supply projects at issue and gas storage projects are efforts by pipelines to enhance the availability of gas supply. They both supplement system gas supplies. They are also reviewed under the same statutory standards. There is no factual or statutory distinction which justifies the different treatment accorded the projects at issue from failed gas storage projects.

One explanation for the inconsistent rate treatment accorded Natural's projects is an unjustified hostility to nontraditional gas supply projects. No evidence or findings in this case support the court's characterization that these technologies are "exotic" and "unproven". App. 35a. Far from being experimental or unproven, many LNG and SNG facilities are currently in operation providing reliable and cost-effective service to consumers.

There are currently thirteen operational SNG from liquid hydrocarbon facilities in the United States. Several have provided needed gas to the greater Washington, D.C. area for many years. SNG facilities have produced over 1.5 trillion cubic feet of gas since 1976. A number of plants have been in operation since the early 1970s. The technology is well understood and the operational experience is broadly available. Additional research and development work is now underway to improve the processes and not to validate the technology. As such, SNG from liquid hydrocarbons is based on a mature technology.[4]

---

[4] American Gas Association, *Status of SNG-from-Liquid Hydrocarbon Plants*, Gas Energy Review, Aug. 1985 at 17.

The SNG technology needed to manufacture significant amounts of pipeline quality gas from coal is also readily available. This technology has been used commercially outside of the United States for many years. By the late 1970s the gas industry had already invested over $130 million to develop commercial-scale coal gasification projects in this country. It has been regulatory delay and financing constraints rather than technological uncertainty which has slowed the commercial use of coal gasification in this country. Because coal gas can use the nation's vast coal reserves in an efficient and environmentally sound manner, it has long been considered one of the most attractive supplemental sources of gas energy.[5]

Similarly, LNG is also a mature technology providing substantial quantities of cost-effective gas to consumers. The basic technology required to support an expanded LNG export and import industry has been operational for over 20 years. There are currently over 100 LNG peak-shaving and base-load plants in operation worlwide. In addition, in 1978 there were over 11 operating LNG trade projects, with annual deliveries of approximately 1.6 trillion cubic feet of gas per year.[6] Many cities throughout the United States depend on LNG to provide essential peak period energy and to supplement base-load supplies. LNG facilities are neither exotic nor unproven.

The Court of Appeals has not applied any reasoned analysis or rationale for the inconsistent rate treatment accorded Natural's abandoned projects. This inconsistent treatment financially injures Natural and has an unwarranted, chilling effect on the development of LNG, SNG and other nontraditional gas supply projects.

---

[5] American Gas Association, *Fact Book: Synthetic Pipeline Gas From Coal*, Sept. 1979.

[6] Sarkes, Iribe and Smith, *LNG: Current Status Confirms Its Technical Maturity*, Pipeline and Gas Journal, Nov. 1978.

CONCLUSION

For the forgoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

GEORGE H. LAWRENCE
DAVID J. MUCHOW
*CAROL A. SMOOTS

By Carol A. Smoots

*Counsel of Record for the
American Gas Association
1515 Wilson Boulevard
Arlington, Virginia 22209
(703) 841-8461

December 9, 1985

Supreme Court, U.S.
FILED
DEC 9 1985
JOSEPH F. SPANIOL, JR.
CLERK

No. 85-592

IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

NATURAL GAS PIPELINE COMPANY OF AMERICA,
Petitioner,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
Respondent.

REPRINTED COPY

On Petition for a Writ of *Certiorari* to the United States Court of Appeals for the District of Columbia Circuit

BRIEF OF *AMICUS CURIAE*

Of Counsel:

JOHN T. KETCHAM
TED P. GERARDEN
JOSEPH O. FRYXELL

McGEE & KETCHAM, P.C.
1140 Connecticut Ave., N.W.
Suite 1140
Washington, D.C. 20036
(202) 331-7272

JOHN H. CHEATHAM, III
EDWARD E. MYERS
1660 L Street, N.W.
Washington, D.C. 20036
(202) 293-5770

Attorneys for
INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA

December 9, 1985

BEST AVAILABLE COPY

PRESS OF BYRON S. ADAMS, WASHINGTON, D.C. (202) 347-8203

TABLE OF CONTENTS

	Page
TABLE OF CONTENTS	i
TABLE OF AUTHORITIES	ii
INTEREST OF *Amicus Curiae*	2
CONSENT OF PARTIES	3
ARGUMENT	3
A. The Commission Permits Cost Recovery Under the Federal Power Act in Similar Circumstances for Competitive Projects of Electric Utility Companies	5
B. Interstate Natural Gas Pipelines Must Undertake Gas Supply Projects To Meet Obligations Arising Under Certificates of Public Convenience and Necessity	8
C. The Commission's Rejection of Cost Recovery for Certain Projects Is Arbitrary and Capricious Where Cost Recovery Is Permitted for Comparable Projects	13
CONCLUSION	17

TABLE OF AUTHORITIES

CASES: Page

Arkansas Louisiana Gas Company v. Hall, 453 U.S. 571 (1981) 5

California v. Southland Royalty Company, 436 U.S. 519 (1978) 9

City of Winnfield, La. v. Federal Energy Regulatory Commission, 744 F.2d 871 (D.C. Cir. 1984) .. 5

Federal Power Commission v. Hope Natural Gas Company, 320 U.S. 591 (1944) 13

Federal Power Commission v. Sierra Pacific Power Company, 350 U.S. 348 (1956) 5

Jersey Central Power & Light Company v. FERC, 768 F.2d 1500, n. 4 (D.C. Cir. 1985) 15, 16

Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission, 262 U.S. 276 (1923) 16

Natural Gas Pipeline Company of America v. Federal Energy Regulatory Commission, 765 F.2d 1155 (D.C. Cir. 1985) ..... *Passim*

NEPCO Municipal Rate Committee v. Federal Energy Regulatory Commission, 668 F.2d 1327 (D.C. Cir. 1981), *cert. denied*, 457 U.S. 1117 (1982) 6

Washington Gas Light Co. v. Baker, 188 F.2d 11 (D.C. Cir. 1950) 16

ADMINISTRATIVE CASES:

Algonquin Gas Transmission Company, Opinion No. 233, 31 FERC ¶61,221, *rehearing denied*, Opinion No. 233-A, 33 FERC ¶61,083 (1985) 5

Columbia Gas Transmission Corporation, 26 FERC ¶61,034 (1984) 9, 10

Eascogas LNG, Inc., Opinion No. 680, 50 FPC 2075 (1973) 11

Gulf Oil Corporation, Opinion No. 692-A, 52 FPC 593 (1974) 9

Table of Authorities (Continued)

Page

Natural Gas Pipeline Company of America, Opinion No. 218, 27 FERC ¶61,201, *rehearing denied*, Opinion No. 218-A, 28 FERC ¶61,020 (1984) ..... *Passim*

New England Power Company, Opinion No. 49, 8 FERC ¶61,054 (1979), *aff'd sub nom., NEPCO Municipal Rate Committee v. Federal Energy Regulatory Commission*, 668 F.2d 1327 (D.C. Cir. 1981), *cert. denied*, 457 U.S. 1117 (1982) 6

New England Power Company, Opinion No. 231, 31 FERC ¶61,047 (1985) 6

Northern Natural Gas Company, 45 FPC 1050 (1971) 15

Ozark Gas Transmission System, Opinion No. 125, 16 FERC ¶61,099, and Opinion No. 125-A, 17 FERC ¶61,027 (1981) 14

Panhandle Eastern Pipe Line Company, Opinion No. 344, 25 FPC 787 (1961) 15

Phillips Petroleum Company, Opinion No. 338, 24 FPC 537 (1960) 15

Southern Natural Gas Company, Opinion No. 329, 29 FPC 323 (1963) 15

Tennessee Gas Pipeline Company, a Division of Tenneco, Inc., 21 FERC ¶61,004 (1982) 9

Tennessee Gas Pipeline Company, a Division of Tenneco, Inc., Opinion No. 240, 32 FERC 61,086 (1985) 5, 14

Trailblazer Pipeline Company, Opinion No. 138, 18 FERC ¶61,244 (1981) 12, 14

Transcontinental Gas Pipe Line Corporation, Opinion No. 801, 58 FPC 2038, and Opinion No. 801-A, 59 FPC 1237 (1977), *aff'd Tennessee Gas Pipeline Company v. Federal Energy Regulatory Commission*, 606 F.2d 1094 (D.C. Cir. 1979) *cert. denied*, 445 U.S. 920 and 447 U.S. 922 (1980) 5

Table of Authorities (Continued)

	Page
Transwestern Pipeline Company, 28 FERC ¶61,086 (1984)	5
Union Electric Company, 8 FERC ¶63,026 (1979), *aff'd*, Opinion No. 94, 12 FERC ¶61,239 (1980)	6
STATUTES & REGULATIONS:	
Department of Energy Organization Act, 42 U.S.C. §7101, *et seq.* (1978)	2
Federal Power Act, 16 U.S.C. § 791a *et seq.* (1985)	2, 5
Section 201, 16 U.S.C. § 824	7
Natural Gas Act, 15 U.S.C. § 717 *et seq.* (1984)	2, 5, 15
Section 7, 15 U.S.C. § 717f	2, 7, 8
Natural Gas Policy Act of 1978, 15 U.S.C. 3301, *et seq.* (1984)	2, 9
Sales and Transportation by Interstate Pipelines and Distributors, FERC Statutes & Regulations ¶32,132 (1981)	9
MISCELLANEOUS:	
"Gas Supplies of Interstate Natural Gas Pipeline Companies 1983," Energy Information Administration, DOE/EIA-0167(83) (1984)	10

IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

No. 85-592

NATURAL GAS PIPELINE COMPANY OF AMERICA,
Petitioner,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
Respondent.

On Petition for a Writ of *Certiorari* to the United States Court of Appeals for the District of Columbia Circuit

---

BRIEF OF *AMICUS CURIAE*

This *amicus curiae* brief is respectfully submitted pursuant to Rules 21 and 36 of this Court by the Interstate Natural Gas Association of America ("INGAA") in support of the Petition for Writ of *Certiorari* of Natural Gas Pipeline Company of America ("Natural").

INTEREST OF *AMICUS CURIAE*

INGAA is a nonprofit national trade association representing virtually all of the major long-distance natural gas transmission companies in the United States. These companies are subject to the regulatory jurisdiction of the Federal Energy Regulatory Commission ("Commission" or "FERC") under the Natural Gas Act ("NGA") (15 U.S.C. § 717, *et seq.* (1984)), the Department of Energy Organization Act (42 U.S.C. § 7101, *et seq.* (1978)), and the Natural Gas Policy Act of 1978 ("NGPA") (15 U.S.C. § 3301, *et seq.* (1984)). A list of INGAA's membership is set forth in the Appendix to this brief.

The Commission's orders, affirmed by the United States Court of Appeals for the District of Columbia Circuit ("Court of Appeals"), deny a pipeline's attempt to recover through its rates costs which were prudently incurred by the pipeline in developing alternate supplies of natural gas to better assure its customers a reliable, long-term supply of natural gas pursuant to its service obligation under Section 7 of the NGA, 15 U.S.C. § 717f (1984). This same service obligation applies to all natural gas pipelines subject to the Commission's jurisdiction. Moreover, the Commission routinely allows electric utilities to recover similar prudently incurred costs under comparable provisions of the Federal Power Act ("FPA"), 16 U.S.C. § 791a *et seq.* (1985). Because the decision of the Court of Appeals has ramifications that extend beyond the facts of this case to the entire interstate natural gas pipeline industry, INGAA is filing this brief *amicus curiae*.

CONSENT OF PARTIES

INGAA has obtained the consent of all parties as required by Rule 42 of this Court. These letters of consent have been filed with the Clerk of the Court.

ARGUMENT

The Court of Appeals affirmed a decision by the Commission which denied, in a rate proceeding under the NGA, any recovery of expenses incurred by Natural in pursuing several gas supply projects.[1] Natural proposed a five-year amortization of approximately $13 million in expenses already incurred (no effort was made by Natural to include these costs in rate base and, therefore, its rate-payers would not bear the carrying costs on that amount). The projects were a synthetic natural gas ("SNG") plant, a liquified natural gas ("LNG") import arrangement, and an Alaskan gas pipeline. All three projects are typical of projects which interstate pipelines turned to with the Commission's encouragement, especially during the severe supply shortage of the 1970's, in an effort to assure adequate reserves to meet ongoing contractual and public service obligations.[2] In Natural's case, as events progressed, all three projects were aban-

---

[1]The Commission's decision is found in *Natural Gas Pipeline Company of America*, Opinion No. 218, 27 FERC ¶61,201, *rehearing denied*, Opinion No. 218-A, 28 FERC ¶61,020 (1984). The Court of Appeals affirmed the Commission in *Natural Gas Pipeline Company of America v. Federal Energy Regulatory Commission*, 765 F.2d 1155 (D.C. Cir. 1985). *See*, Appendix A to Natural's Petition.

[2]As indicated *infra*, page 11, government figures show that the inadequacy of reserves continues despite a current deliverability surplus.

doned—the SNG plant because necessary state permits could not be obtained and because environmental protection requirements changed; the LNG plant because costs for continued participation escalated far beyond original projections; and the Alaskan pipeline because a different route was selected by the Commission.

It is not disputed that Natural acted prudently both in the commencement and in the termination of each project. Nonetheless, the Commission disallowed all costs associated with each project. In doing so it found that the projects were "speculative and uncertain, remote in time, and without benefit to ratepayers."[3] This decision stands in contrast both to the Commission's prior and correct policy of allowing recovery of similar costs arising from other unsuccessful gas supply projects and its current policy relative to abandoned electric generating projects.

If allowed to stand, the *Natural* case will seriously and unfairly impair the ability of pipelines to assure adequate long-term supplies of natural gas to existing customers and to compete with other energy suppliers, including electric utilities, for new customers. Such a policy can only discourage interstate pipelines from undertaking innovative alternate supply projects. This will work to the disadvantage of the ultimate consumer during periods of supply shortfall which are inevitable in a cyclical industry. Such a shortfall could very well result in nationwide gas curtailments similar to those experienced during the 1970's.[4]

---

[3]27 FERC at 61,379.

[4]INGAA notes that other cases have made clear that the Com-

A. The Commission Permits Cost Recovery under the Federal Power Act in Similar Circumstances for Competitive Projects of Electric Utility Companies

The Commission's disallowance of costs in this case is arbitrary and capricious because it creates an unjustifiable distinction between two competing industries it regulates under substantially identical statutory standards.[5] Under the FPA, the Commission has routinely permitted recovery of expenses associated with abandoned electric power generating proj-

---

mission intends to apply its short-sighted policy industry-wide. The Commission recently has denied recovery of costs associated with a coal gasification project in *Transwestern Pipeline Company*, 28 FERC ¶61,086 (1984) (currently on appeal to the United States Court of Appeals for the Fifth Circuit in *Transwestern Pipeline Company v. Federal Energy Regulatory Commission*, No. 84-4753); with an LNG import project in *Algonquin Gas Transmission Company*, Opinion No. 233, 31 FERC ¶61,221, *rehearing denied*, Opinion No. 233-A, 33 FERC ¶61,083 (1985); and with another LNG import project in *Tennessee Gas Pipeline Company, a Division of Tenneco, Inc.*, Opinion No. 240, 32 FERC ¶61,086 (1985). *See also Transcontinental Gas Pipe Line Corporation*, Opinion No. 801, 58 FPC 2038 and Opinion No. 801-A, 59 FPC 1237 (1977), *aff'd, Tennessee Gas Pipeline Company v. Federal Energy Regulatory Commission*, 606 F.2d 1094 (D.C. Cir. 1979), *cert. denied*, 445 U.S. 920 and 447 U.S. 922 (1980).

[5]Electric rate matters come under Commission jurisdiction under the FPA. This Court has noted that the rate provisions of the FPA and the NGA "are in all material respects substantially identical." *Federal Power Commission v. Sierra Pacific Power Company*, 350 U.S. 348, 351 (1956). *See also Arkansas Louisiana Gas Company v. Hall*, 453 U.S. 571, 577 n.7 (1981). The Court of Appeals has noted that the rate provisions of the two statutes are "treated by the courts as identical in substance." *City of Winnfield, La. v. Federal Energy Regulatory Commission*, 744 F.2d 871, 875 (D.C. Cir. 1984).

ects, including nuclear projects.[6] *See, e.g., Union Electric Company,* 8 FERC ¶63,026 (1979), *aff'd,* Opinion No. 94, 12 FERC ¶61,239 (1980); *New England Power Company,* Opinion No. 49, 8 FERC ¶61,054 (1979), *aff'd, sub nom. NEPCO Municipal Rate Committee v. Federal Energy Regulatory Commission,* 668 F.2d 1327 (D.C. Cir. 1981), *cert. denied,* 457 U.S. 1117 (1982).[7]

The efforts by the Commission and the Court of Appeals to rationalize the different results reached under substantially identical statutes are of no avail. First, the Commission explains that a certificate is required for some gas supply projects, and that if a project does not or cannot receive a certificate, costs should not be included. At the same time, the Commission takes the position that because electric generating plants are not subject to any Commission-issued certificate, there is no basis for rejecting costs associated with a prudent but abandoned generating project. 27 FERC at 61,380. The Court of Appeals condoned this distinction as providing a "straightforward" rationale for the disparate treatment attended. 765 F.2d at 1166. This completely overlooks the fact

---

[6]"In the electric rate-making area, the Commissioner's policy has been to allow public utilities to recover prudently incurred investment costs in a generating project that is ultimately abandoned or cancelled." *New England Power Company,* Opinion No. 231, 31 FERC ¶61,047, 61,081 (1985) (footnote omitted).

[7]In *NEPCO,* the Court of Appeals rejected arguments to include project expenditures in rate base (thus permitting a return to be earned), but accepted without question the Commission's approval of a five year amortization of expenses incurred. Such amortization is identical to the proposal made herein by Natural but rejected by the Commission and the Court of Appeals.

that two of Natural's projects did not require a certificate. However, notwithstanding the certificate rationale, it remains that a pipelines' prudent expenditures to obtain certificates for gas supply projects should be afforded more favorable treatment than similar expenditures by electric utility companies, since the latter companies do not have to consult the Commission before embarking on multi-billion dollar energy projects. Moreover, once a pipeline accepts a Commission-issued certificate, it *must* go forward with the project unless the Commission authorizes the abandonment of the project. NGA Section 7(b), 15 U.S.C. § 717f(b) (1984). While there may be no "direct analogue" to expenses in pursuit of a certificate, 765 F.2d at 1166, that certainly does not support less favorable cost recovery for prudent pipeline expenditures. Prior to the issuance of a certificate, natural gas projects are on the same footing as electric projects in that the decision to proceed is made solely by the utility's management.

Turning to the two projects of Natural's for which certificates were *not* required, the Commission purports to justify its discriminatory treatment by arguing that projects outside its jurisdiction may end up providing gas for other than Commission-regulated transactions, whereas electric utility companies' sales will be regulated either by the Commission or by states. 27 FERC at 61,380. On this basis, the Court of Appeals agreed that failure of any such project means its costs cannot be recovered in rates. 765 F.2d at 1166-67. This disingenous argument ignores the fact that electric generating plants are also nonjurisdictional, FPA Section 201(b)(1), 16 U.S.C. § 824(b)(1)(1985), and that nothing in the record dem-

onstrates that the pipelines' opportunities to make non-jurisdictional sales are greater than those available to electric utilities. The Commission and the Court of Appeals erred in assuming that the gas supply from Natural's projects, if successful, would have been sold in nonjurisdictional transactions.

Beyond the foregoing errors, the Commission's decision fails to recognize that natural gas pipelines and electric utility companies frequently compete for customers. This is not only true of residential and commercial customers but also industrial energy users. Yet nothing in the Commission's or the Court of Appeals' decisions provides any justification for hamstringing pipelines in their efforts to compete in the energy markets.

Consequently, this case presents this Court with undue discrimination in the regulatory treatment which the Commission accords to natural gas pipelines as compared with the treatment it accords to electric utility companies. The repeated and strained efforts of the Commission and the Court of Appeals to deny a pipeline the recovery of its prudently-incurred unsuccessful project costs both illustrate the fundamental inequity in the orders below and lead further away from the central issue. Interstate natural gas pipelines should not suffer such treatment when the present and future public interest demands that pipelines take advantage of all supply opportunities in order to assure their future certificate obligations.

B. Interstate Natural Gas Pipelines Must Undertake Gas Supply Projects To Meet Obligations Arising Under Certificates of Public Convenience and Necessity

The need for interstate pipelines to incur costs for new gas supply projects stems from obligations attending certificates of public convenience and necessity issued by the Commission pursuant to Section 7 of the NGA. Pipelines holding such certificates have, independent of their private contract obligations, a public interest obligation to assure sufficient supply to meet certificated service requirements. *Gulf Oil Corporation,* Opinion No. 692-A, 52 FPC 593, 596 (1974); *see also, California v. Southland Royalty Company,* 436 U.S. 519 (1978). The Commission has repeatedly reminded pipelines that they have a primary obligation to obtain gas supplies. In one case, the Commission stated:

> "The Commission has traditionally placed the primary responsibility for a long-term balancing of gas supply and demand upon the interstate pipelines. * * * Although the Commission's direct jurisdiction over [certain] sales has been partially removed, *the pipeline's responsibility to its customers to acquire an assured long-term supply of gas under favorable terms remains.* * * *" *Tennessee Gas Pipeline Company, a Division of Tenneco, Inc.,* 21 FERC ¶61,004, 61,006-61,007 (1982) (emphasis added, footnote omitted), citing Sales and Transportation by Interstate Pipelines and Distributors, FERC Statutes & Regulations, ¶32,132, 33,191 n.11 (1981).

Also, compare the Commission's decision in *Columbia Gas Transmission Corporation,* 26 FERC ¶61,034 (1984), where the Commission reaffirmed the continuing duty of pipelines to assure adequate supplies of gas that have been price deregulated under the

NGPA. The Commission's decision in *Columbia* is pending appeal to the United States Court of Appeals for the District of Columbia Circuit, *Office of Consumers Counsel v. Federal Energy Regulatory Commission,* No. 84-1099.

Furthermore, it is well documented that, notwithstanding the current deliverability surplus, proven reserves of conventional gas supplies are declining. Indeed, Department of Energy statistics show that the proven reserves of natural gas dedicated to interstate pipeline companies have declined by over 8.5 trillion cubic feet over the past two years.[8] Under such circumstances, it is only prudent for interstate natural gas pipelines to turn to alternate sources of supply, *e.g.,* LNG, SNG, or other gas supply projects, to meet their future service obligations.[9]

In light of the potential impact of its policy on the interstate natural gas pipeline industry as well as natural gas consumers, the Commission's action is inconsistent. On the one hand, the Commission appears beguiled by the current gas *deliverability* (*i.e.* not gas reserves or supply) surplus and is willing to ignore the future needs of natural gas pipelines and consumers. Yet, in earlier cases when the supply shortfall was immediate, the Commission acknowledged it as an emergency and expounded on the need for new gas supply sources. For example, when Eascogas

---

[8]"Gas Supplies of Interstate Natural Gas Pipeline Companies 1983," Energy Information Administration, DOE/EIA-0167(83), p. 52 (1984).

[9]In fact, if pipelines fail to do so, they may face accusations by customers, during supply shortfall, that they have been derelict in their duty to secure reliable long-term supplies.

LNG, Inc. sought Commission approval of its proposal to construct an LNG project to provide base-load LNG service to New England gas consumers, the Commission had little doubt of the need for the gas supply as is obvious from the following opening language from the Commission's opinion:

> "The United States is confronted with a national energy emergency.
>
> "It is the clear responsibility of all agencies of the United States Government to respond to, and to take actions to alleviate, this emergency to the fullest extent of their legal authority. The Commission has long been mindful of mounting shortages in energy supply, as evidenced by its Opinions and orders and by the public statements of its members over many months. We are thus prepared, and indeed anxious, to respond to the current emergency within the scope of our responsibilities, and we are willing to do so by taking any necessary and reasonable action permitted by law which will assist in alleviating the current crisis and which is consistent with the public interest.
>
> "We take expedited action today in these consolidated proceedings, for we are convinced that only by so doing, a project that promises substantial supplies of imported natural gas for New Jersey and the New England States will not be jeopardized by regulatory inaction." *Eascogas LNG, Inc.*, Opinion No. 680, 50 FPC 2075, 2077 (1973) (footnote omitted).

Moreover, in other contexts, the Commission has recognized that it must encourage investment in economically sound incremental supply projects through a sharing of the risk between pipelines and consumers. *Trailblazer Pipeline Company,* Opinion No. 138, 18 FERC ¶61,244, 61,503 (1981). In *Trailblazer,* the Commission described the dilemma confronting the pipelines as follows:

> "If regulated companies cannot reap the benefits of good fortune, they should not be expected to bear the burdens of bad fortune. If the best that they can hope for are rates that just cover their cost (including a fair return), they cannot be expected to undertake projects that carry a significant risk of falling short of covering those costs. And it would seem to stretch the limits of the law to try to force companies to undertake such projects in order to maintain service. Thus, either such projects will not be undertaken by the regulated companies, or the risk must be at least shared between investors and consumers.
>
> * * * * *
>
> "These policy considerations have led the Commission in the direction of a consistent and more liberal allowance of abandoned plant costs in cost of service. That trend subscribes in essence to the view that undertaking new supply projects resulting in the incurrence of costs to maintain or improve service, or ultimately to improve productivity (lower costs), is as much a part of the cost of service as other components historically and consistently treated as part of the cost of service. * * *" 18 FERC at 61,502.

and consistently treated as part of the cost of service. * * *" 18 FERC at 61,502.

The result reached by the Court of Appeals in this case, however, is squarely at odds with the Commission's expressed determination to provide a balanced sharing of risks in new supply projects.[10]

C. The Commission's Rejection of Cost Recovery for Certain Projects Is Arbitrary and Capricious Where Cost Recovery Is Permitted for Comparable Projects

The Court of Appeals advanced a series of distinctions to support its decisions to deny cost recovery for the unsuccessful gas supply projects presented here, but to permit cost recovery for other unsuccessful conventional gas supply projects involving storage. These distinctions which seem to be based on the "used and useful concept" are *not* contained

---

[10]The Supreme Court has required that any rate action by the Commission reach a just end result, a process which involves a "balancing of the investor and the consumer interests." *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591, 602-603 (1944). The ultimate impact of the Commission's and the Court of Appeals' actions here, however, is that only the consumers' immediate or short-term interests are acknowledged. Although Natural was working to meet service obligations under its certificates, and raising necessary capital to do so in pursuit of replacement gas supply projects, the Commission's decision flatly to exclude such cost recovery clearly ignores the consumers' long-term interest in continuing service, including the viability of the pipeline industry which is an essential component of such service.

in the Commission's opinions but appear for the first time in the Court's decision.[11] The distinctions are strained and without real difference, and the Commission's action is arbitrary and capricious and an abuse of discretion. The failure of the Court of Appeals to correct this unlawful administrative action requires the granting of Natural's Petition.

The Commission has acknowledged that its policy toward costs incurred in the pursuit of unsuccessful projects has been uncertain and inconsistent.[12] Its policy remains inconsistent and arbitrary in the present case, where the Commission denied Natural any cost recovery under existing policy but at the same time articulated new factors involving prudence under which it may grant future requests for such recovery.[13] This inconsistency is aggravated, moreover, be-

---

[11]While INGAA does not wish to belabor the point here, INGAA submits that a reviewing Court should not supply the agency with a rationale to harmonize conflicting precedent especially where, as shown in *Trailblazer, supra,* the agency concedes the inconsistency (see the next footnote).

[12]As the Commission itself put it in *Trailblazer, supra,* "[t]he *Ozark* [*Ozark Gas Transmission System,* Opinion No. 125, 16 FERC ¶61,099 and Opinion No. 125-A, 17 FERC ¶61,024 (1981)] case points out that Commission treatment of the issue of abandoned plants in rate proceedings has been uncertain. In fact, it has been characterized by a somewhat distressing degree of inconsistency. That inconsistency is important because it tends to leave both lenders and equity investors with a sense of uncertainty as to how the Commission will treat unsuccessful investments in new energy supply projects. * * * " 18 FERC at 61,501.

[13]The Commission did apply its newly announced factors in the *Tennessee* case, *supra,* 32 FERC 61,231-32, a case in which the record had closed before issuance of the new standard in *Natural.* Finding that Tennessee did not meet the new standards, the Commission denied recovery in that instance of costs associated with a failed LNG project.

cause the Court of Appeals introduced its own rationale based on a "used and useful" test.[14]

Where, as here, such costs have been prudently incurred, the Commission routinely has permitted pipelines to recover costs associated with failed projects, such as failed gas storage projects. *See, e.g., Northern Natural Gas Company,* 45 FPC 1050 (1971); *Southern Natural Gas Company,* Opinion No. 329, 29 FPC 323, 331-32 (1963). Similarly, recovery has been allowed for dry hole costs. *See, e.g., Panhandle Eastern Pipeline Company,* Opinion No. 344, 25 FPC 787 (1961); *Phillips Petroleum Company,* Opinion No. 338, 24 FPC 537 (1960). These decisions came under the same rate provisions of the NGA as are applicable here.

The Court of Appeals distinguished Natural's projects from these situations, first on the ground that storage is unlike production,[15] and then on the ground that dry wells are sufficiently unlike Natural's proj-

---

[14]It warrants observation in this connection that even where the used and useful test has been considered for purposes of determining rate base, the court below has indicated its preference for a prudent investment test. *Jersey Central Power & Light Company v. Federal Energy Regulatory Commission,* 768 F.2d 1500, 1504, n. 4 (D.C. Cir. 1985). Accordingly, INGAA is hard put to understand the reasoning behind the Court of Appeals' apparent reliance in the instant case on a used and useful standard.

[15]Even if one accepts this distinction, it would not justify the Commission's treatment of Natural's LNG project. That project simply involved the purchase, importation, and storage of LNG for subsequent delivery to customers when needed. The only difference between an LNG project and other storage projects is the fact that the gas is stored as a liquid rather than in a gaseous state.

ects so as to permit different treatment. 765 F.2d at 1165. But nowhere does the Court of Appeals attempt to reconcile the obvious conflict created between a pipeline's need to meet its long-term service obligations and the Commission's discrimination against recovery of prudently incurred expenses associated with its unsuccessful gas supply projects.

The Court of Appeals also relied heavily on the concept of "used and useful" to decide what expenses are allowable. 765 F.2d at 1156-58, 1161. This is in error. The "used and useful" concept is not applicable to cost recovery where regulation is undertaken under the prudent investment approach to rate making. *See Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission*, 262 U.S. 276, 290 (1923) (Mr. Justice Brandeis, concurring); *Washington Gas Light Co. v. Baker*, 188 F.2d 11 (D.C. Cir. 1950). Additionally, subsequent to the decision below in the instant case, the same Court of Appeals (but a different panel) has questioned the Commission's authority to disallow any element of cost by an electric utility, including return on investment, under the foregoing authorities. *Jersey Central, supra.* Because of the obvious confusion in the Court below as to the proper test to apply, it is imperative that this Court hear the instant case to reaffirm the Constitutional and statutory principles applicable to the prudent investment theory of utility ratemaking.

It is arbitrary and capricious, and an abuse of discretion, for the Commission to expect and encourage interstate pipelines to search out needed long-term gas supplies but then draw after-the-fact distinctions among types of projects as to which are eligible for cost recovery and which are not. Pipelines engage in

multifaceted gas procurement activities in pursuit of their certificate obligations to serve their markets. Where such costs are prudently incurred, and absent some rational justification not present here, the Commission must, consistent with its public interest duty, treat the recovery of all such pipeline activities similarly.

CONCLUSION

A writ of *certiorari* should be issued by this Court so that it may review and correct the Commission's erroneous and arbitrary action, thereby insuring that the interests of the interstate natural gas pipeline industry and natural gas consumers are protected.

Respectfully submitted,

Of Counsel:

JOHN T. KETCHAM
TED P. GERARDEN
JOSEPH O. FRYXELL
McGEE & KETCHAM,P.C.
1140 Connecticut Avenue, N.W.
Suite 1140
Washington, D.C. 20036
(202) 331-7272

JOHN H. CHEATHAM, III
EDWARD B. MYERS
1660 L Street, N.W.
Washington, D.C.
(202) 293-5770

Attorneys for
INTERSTATE NATURAL GAS
ASSOCIATION OF AMERICA

APPENDIX

APPENDIX

INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA MEMBERSHIP

Active Membership

Alabama-Tennessee Natural Gas Company
Algonquin Gas Transmission Company
Arkla Energy Resources Company
The Coastal Corporation
The Columbia Gas System, Inc.
Consolidated Natural Gas Company
El Paso Natural Gas Company
Granite State Gas Transmission Inc.
Great Lakes Gas Transmission Company
HNG-InterNorth
Kentucky West Virginia Gas
KN Energy, Inc.
Locust Ridge Gas Company
Michigan Gas Storage Company
MidCon Corp.
Mid Louisiana Gas Company
Northwest Energy Company
Pacific Gas Transmission Company
Pacific Interstate Transmission Company
Panhandle Eastern Corporation
Ringwood Gathering Company
Southern Natural Gas Company
Tennessee Gas Transmission Company
Texas Eastern Transmission Corporation
Texas Gas Transmission Corporation
Texas Oil & Gas Corporation
Transcontinental Gas Pipe Line Corporation
United Gas Pipe Line Company
Valero Interstate Transmission Company
Valley Gas Transmission, Inc.

Associate Members

Amoco Production Company
ARCO Oil and Gas Company
Atlanta Gas Light Company
The Brooklyn Union Gas Company
Champlin Petroleum Company
Chevron USA
Cities Service Oil and Gas Corporation
Conoco Inc.
Entex, Incorporated
Exxon Company, U.S.A.
Gulf Oil Exploration and Production Company
John H. Hill
Kerr-McGee Corporation
Kinsey Interests, Inc.
Laclede Gas Company
Lear Petroleum Exploration Company
Marathon Oil Company
Minerals, Inc.
Mitchell Energy & Development Corporation
National Fuel Gas Company
NUI Corporation
Phillips Petroleum Company
Shell Oil Company
Southern California Gas Company
Sun Exploration & Production Company
Texaco U.S.A.
Union Oil Co. of California

Supreme Court, U.S.
FILED
DEC 11 1985
JOSEPH F. SPANIOL, JR.
CLERK

No. 85-592

In the Supreme Court of the United States

OCTOBER TERM, 1985

NATURAL GAS PIPELINE COMPANY OF AMERICA,
PETITIONER

v.

FEDERAL ENERGY REGULATORY COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

MEMORANDUM FOR THE FEDERAL ENERGY REGULATORY COMMISSION IN OPPOSITION

CHARLES FRIED
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

WILLIAM H. SATTERFIELD
General Counsel

BARBARA J. WELLER
Deputy Solicitor

LESLIE J. LAWNER
Attorney
Federal Energy Regulatory Commission
Washington, D.C. 20426

BEST AVAILABLE COPY

TABLE OF AUTHORITIES

Page

Cases:

FPC v. *Hope Natural Gas Co.*, 320 U.S. 591 5

FPC v. *Memphis Light, Gas & Water Division* 411 U.S. 458 5

FPC v. *Natural Gas Pipeline Co.*, 315 U.S. 575 5

FPC v. *Sunray DX Oil Co.*, 391 U.S. 9 5

Mobil Oil Corp. v. *FPC*, 417 U.S. 283 5

Northwestern Public Service Co. v. *FPC*, 522 F.2d 654 5

Transcontinental Gas Pipe Line Corp., 58 F.P.C. 2038 aff'd and remanded *sub nom. Tennessee Gas Pipeline Co.* v. *FERC*, 606 F.2d 1094, cert. denied, 445 U.S. 920 and 447 U.S. 922 2

Statutes:

Natural Gas Act, 15 U.S.C. 717-717w 1

In the Supreme Court of the United States

OCTOBER TERM, 1985

No. 85-592

NATURAL GAS PIPELINE COMPANY OF AMERICA,
PETITIONER

v.

FEDERAL ENERGY REGULATORY COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

MEMORANDUM FOR THE FEDERAL ENERGY REGULATORY COMMISSION IN OPPOSITION

Petitioner Natural Gas Pipeline Company of America contends that the court of appeals erred in affirming the Federal Energy Regulatory Commission's orders refusing to allow it to recover from its ratepayers amounts expended for unsuccessful projects to procure new and unconventional gas supplies.

1. Natural is an interstate pipeline company whose sales of natural gas in interstate commerce are regulated by the Commission under the Natural Gas Act, 15 U.S.C. 717-717w. In this case the Commission denied Natural's effort to recover through the rates it charges for its gas the costs it expended in pursuing three unconventional gas projects. The three projects included acquiring leases and an option to property on which to construct a synthetic natural gas facility in North Dakota (the Dunn County project);

acquiring an option to participate in a project to produce liquefied natural gas in Iran (the Kalingas project); and participation in a group studying ways to transport natural gas from Alaska to the lower 48 states (the Gas Arctic project) (see Pet. App. 15a-18a). The Commission concluded that Natural could not recover its losses from these three projects through its rates because from the outset these projects were of an unusually risky nature and they ultimately failed to produce or deliver any gas at all to Natural or its customers (Pet. App. 39a-54a).

The court of appeals upheld the Commission's orders as "a reasoned exercise of its discretion under section 4 of the Natural Gas Act, 15 U.S.C. § 717c" (Pet. App. 12a). The court of appeals recognized both the Commission's long-standing practice of denying recovery of the costs of failed gas supply projects in a pipeline's rates (Pet. App. 19a-20a, 22a) and judicial approval of this practice (Pet. App. 22a-24a).[1] The court of appeals again placed its imprimatur on the Commission's policy of denying a "natural gas pipeline any recovery of costs from supply projects that entirely failed to benefit ratepayers" (Pet. App. 25a-26a). In so doing, the court first rejected Natural's argument that since it acted prudently in expending these costs, it should be allowed to recover them. The court assumed prudent management by Natural, but held that the Natural Gas Act does not make ratepayers guarantors of speculative investments and the Commission can properly find that ratepayers should not be "stuck with the bill" for failed projects (Pet. App. 26a). The court also rejected Natural's argument that the Commission had acted inconsistently by denying its

---

[1]See, *e.g.*, *Transcontinental Gas Pipe Line Corp.*, 58 F.P.C. 2038 (1977), aff'd in relevant part and remanded on other grounds *sub nom. Tennessee Gas Pipeline Co.* v. *FERC*, 606 F.2d 1094 (D.C. Cir. 1979), cert. denied, 445 U.S. 920 and 447 U.S. 922 (1980).

request since the Commission permits the recovery of costs for unsuccessful pipeline storage projects, dry holes drilled by natural gas producers, and unsuccessful electric generation projects (Pet. App. 27a). The court found that the Commission acted properly in distinguishing Natural's request since the Commission "plausibly viewed these three projects as unusually risky ventures" (Pet. App. 30a).

2. The decision below is correct and does not conflict with the decisions of any other court of appeals. Petitioner's fact-bound contentions do not warrant further review.

a. Natural argues (Pet. 10-13) that the Commission's prohibition of recovery of the costs expended in its failed projects was arbitrary because in allegedly similar cases the Commission has permitted utilities to recover expenditures. However, both the Commission and the court of appeals amply demonstrated why the cases on which Natural relies are in fact dissimilar and warrant different treatment.

Natural first argues (Pet. 11) that gas storage projects, for which costs have been allowed even where the project did not succeed, are indistinguishable from the supply projects at issue here. Natural baldly asserts that storage facilities are primarily used for supply enhancement, the same purpose which would have been served by Natural's three failed projects. But, as the court of appeals explained, a pipeline must have storage facilities and "efforts to find and secure those facilities are essential to maintaining the ordinary equipment of a pipeline" (Pet. App. 28a). Efforts to enhance supply, in contrast, are normal activities of producers, not pipelines; "Natural has offered no reason why a pipeline should not be treated like other gas producers when the pipeline attempts to act as a gas producer" (*ibid.*).

Natural also argues (Pet. 11-13) that since electric utilities are permitted cost recovery of expenditures for abandoned nuclear projects, it should receive the same treatment for its abandoned projects. But as the court of appeals noted (Pet. App. 31a), the different treatment is justified by both the varying statutory schemes and the different policies involved in allocating the risks in the two areas. Under Section 7 of the Natural Gas Act, 15 U.S.C. 717f, the Commission certificates all jurisdictional services and facilities, assuring that they will remain in and benefit the interstate gas market. There is no analogous certification process on the electric side. The Commission has therefore developed a prudent investment test to determine if ratepayers should bear the expense of abandoned electric projects, although it normally determines whether ratepayers should bear the cost of gas projects depending on whether a certificate was obtained. As the court of appeals concluded, the difference in the statutory schemes "supports the Commission's different treatment of expenses from the Gas Arctic project and expenses from failed [electric] generation projects in a straightforward way" (Pet. App. 31a-32a), since all the money Natural lost in the Gas Arctic project was spent in unsuccessful pursuit of a certificate. In addition, the Commission's refusal to allow Natural to recover the costs of its Dunn County and Kalingas projects stemmed in part from the fact that they are non-jurisdictional and that the pipelines' jurisdictional customers are not assured of benefiting from such projects even if they succeed, so that they should not be burdened with the costs if they fail. But the critical distinction between the Dunn County and Kalingas projects and the electric projects for which the Commission has approved rate recovery is that the nature of and the likelihood of success for the failed projects here were far more speculative than for the electric projects for which the Commission has approved rate recovery (Pet. App. 33a, 35a-36a).

b. Natural alleges (Pet. 13-15) that the Commission and the court of appeals erred in failing to consider the effect that denial of recovery of its costs would have on its financial health, citing *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944), and *FPC* v. *Memphis Light, Gas & Water Division*, 411 U.S. 458, 465-466 (1973). As this Court stated in *Hope Natural Gas*, rates are "just and reasonable" only if consumer interests are protected and the financial health of the pipeline remains strong. The rate set must fall within the "zone of reasonableness"; it must not be so low as to be confiscatory in the constitutional sense. See *FPC* v. *Natural Gas Pipeline Co.*, 315 U.S. 575, 585 (1942). In order for Natural to succeed in challenging the rates allowed by the Commission in this case, it must show that the rates fall outside the zone of reasonableness. *Northwestern Public Service Co.* v. *FPC*, 522 F.2d 654, 660 (D.C. Cir. 1975); see also *Mobil Oil Corp.* v. *FPC*, 417 U.S. 283, 321 (1974); *FPC* v. *Sunray DX Oil Co.*, 391 U.S. 9, 29 (1968); As the court of appeals noted, Natural not only failed to show that its rates are outside the zone of reasonableness, it did not even allege that this is the case (Pet. App. 27a). Therefore, the court of appeals correctly rejected Natural's contention.

c. Finally, Natural argues (Pet. 15-16) that the court of appeals erred in determining that the Commission's findings that Natural's projects did not benefit ratepayers and were unlikely to do so is supported by substantial evidence. It is of course undisputed that the projects did not benefit ratepayers. Furthermore, as the Commission and the court of appeals concluded, the record clearly supports the conclusion that "these three projects were unusually risky ventures" (Pet. App. 30a). In any event, whether they were likely to benefit ratepayers, as Natural contends, is a factual issue not warranting this Court's attention.

It is therefore respectfully submitted that the petition for writ of certiorari should be denied.

CHARLES FRIED
Solicitor General

WILLIAM H. SATTERFIELD
General Counsel

BARBARA J. WELLER
Deputy Solicitor

LESLIE J. LAWNER
Attorney
Federal Energy Regulatory Commission

DECEMBER 1985

DOJ-1985-12